No. 85-1080

Supreme Court, U.S.
FILED
DEC 23 1985
JOSEPH F. SPANIOL, JR.
CLERK

IN THE
Supreme Court of the United States

October Term, 1985

SAN DIEGO GAS & ELECTRIC COMPANY,
Appellant,

v.

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Appellee.

ON APPEAL FROM THE SUPREME COURT OF CALIFORNIA

JURISDICTIONAL STATEMENT OF APPELLANT SAN DIEGO GAS & ELECTRIC COMPANY

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QUESTIONS PRESENTED

Has a utility been denied due process when a public utilities commission has determined that a past utility action was imprudent and ordered the utility to refund $45 million to its ratepayers which the utility expended pursuant to that action—

1. Where the commission judged the action from hindsight instead of from the perspective of circumstances existing when the action was taken?

2. Where the imprudence finding and refund order are not supported by any evidence and are contrary to undisputed evidence?

3. Where there was no evidence or finding that prudent management would have avoided any of the utility's disallowed expenses, and the commission excluded the utility's evidence which went to that issue?

4. Where the commission had twice previously approved the utility's recovery of expenditures for this action, and denied the utility any opportunity to mitigate its costs therefor?

THE PARTIES TO THIS PROCEEDING

The parties to this proceeding are: (1) San Diego Gas & Electric Company (SDG&E), Appellant; (2) the Public Utilities Commission of the State of California (Commission), Appellee; and the City of San Diego (City), Intervenor.

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OPINIONS BELOW

SDG&E appeals from the final judgment of the California Supreme Court denying a Writ of Review of two decisions of the California Public Utilities Commission. The state Supreme Court's denial of the Writ of Review, which appears at page A-74 in the Appendix hereto, is not reported. The opinions of the Commission presented for review are *Application of SDG&E*, Decision No. 84-02-005, slip op. (Cal. P.U.C., Feb. 2, 1984), and *Application of SDG&E*, Decision No. 84-12-026, slip op. (Cal. P.U.C., Dec. 5, 1984), as modified by *Application of SDG&E*, Decision No. 85-04-111, slip op. (Cal. P.U.C., Apr. 17, 1985), and are printed in the Appendix hereto, pages A-1 through A-73.

JURISDICTION

The judgment of the California Supreme Court denying appellant's Writ of Review was entered on September 24, 1985. A Notice of Appeal to this Court was duly filed in the Supreme Court of California on December 2, 1985 (Appendix, p. A-75). The jurisdiction of this Court is invoked under Title 28 United States Code, Section 1257(2). For the purposes of appeal under this statute, an order of the Commission is deemed equivalent to an act of the legislature. *Atchison, Topeka & Santa Fe Railway Co. v. Public Utilities Commission of California*, 346 U.S. 346, 348-349 (1953); *Live Oak Water Users' Association v. Railroad Commission of California*, 269 U.S. 354, 356 (1926).

This appeal is being docketed in this Court within 90 days from the denial of the Writ of Review below.

CONSTITUTIONAL AND STATUTORY PROVISIONS

The United States Constitution, Fifth Amendment: "No person shall . . . be deprived of life, liberty, or property, without due process of law. . . ."

United States Constitution, Fourteenth Amendment, Section 1: ". . . No State shall . . . deprive any person of life, liberty, or property, without due process of law. . . ."

California Constitution, Article XII, Section 2: "Subject to statute and due process, the commission may establish its own procedures. Any commissioner as designated by the commission may hold a hearing or investigation or issue an order subject to commission approval."

California Constitution, Article XII, Section 6: "The commission may fix rates, establish rules, examine records, issue subpoenas, administer oaths, take testimony, punish for contempt, and prescribe a uniform system of accounts for all public utilities subject to its jurisdiction."

California Public Utilities Code, Section 451: "All charges demanded or received by any public utility . . . for . . . any service rendered or to be rendered shall be just and reasonable. Every unjust or unreasonable charge demanded or received for such . . . service is unlawful."

California Public Utilities Code, Section 701: "The commission may supervise and regulate every public utility in the State and may do all things, whether specifically designated in this part or in addition thereto, which are necessary and convenient in the exercise of such power and jurisdiction."

California Public Utilities Code, Section 728: "Whenever the commission, after a hearing, finds that the rates . . . observed, charged, or collected by any public utility for or in connection with any service . . . are insufficient, unlawful, unjust, unreasonable, discriminatory, or preferential, the commission shall determine and fix, by order, the just, reasonable, or sufficient rates . . . to be thereafter observed and in force. . . ."

STATEMENT OF THE CASE

San Diego Gas & Electric Company (SDG&E) is a combined gas and electric utility serving approximately 875,000 electric and 560,000 gas customers in the southwestern corner of the United States. At the end of 1978, SDG&E met most of its electric load through gas- and oil-fired on-system generation, and spent approximately 50 percent of its revenue dollar on gas and oil fuels for its powerplants. At that time, SDG&E purchased almost all of its oil under two long-term contracts: One with Hawaiian Independent Refinery, Inc. (HIRI); and the other with Tesoro Alaska Petroleum Company (Tesoro).

In 1978 and 1979, SDG&E negotiated a modification to its existing low sulfur fuel oil (LSFO) supply contract with Tesoro by executing the "Restated Agreement." At that time, there was an unanticipated gas supply, below the cost of LSFO, for powerplant use. The utility industry expected this supply to be short-lived. The Restated Agreement reduced SDG&E's obligation to purchase oil in 1979, 1980, and the first half of 1981, to enable SDG&E to take advantage of this excess gas supply. At the same time, the Restated Agreement extended the Tesoro contract by 30 months beyond its scheduled June 30, 1981 expiration to provide for reliable oil supplies in 1982 and 1983 when it appeared powerplant gas would be altogether unavailable. Tesoro seemed a more reliable source for this oil in 1979 than HIRI: Tesoro utilized secure domestic crude supplies and sold LSFO to SDG&E more cheaply than HIRI, whose foreign crude supplies had recently been disrupted and who was consequently forced to reduce its deliveries to SDG&E. Following SDG&E's making of the Restated Agreement, the Commission reviewed SDG&E's expenses and operations in 1980, 1981 and the first half of 1982 under the Restated Agreement and found them prudent, subject only to minor adjustments not pertinent here.

Contrary to all predictions, however, including the Commission's own predictions, natural gas as an electric utility boiler fuel

continued to be available in 1981 and 1982, leaving SDG&E with more contract oil than it could economically burn. At the Commission's prodding, SDG&E in 1982 negotiated a suspension of the 1979 Restated Agreement (the "Suspension Agreement") in return for consideration, commonly referred to as underlift payments, totalling $45 million.

SDG&E recovers its fuel costs and related expenses under a procedure called ECAC (for Energy Cost Adjustment Clause). This is California's version of the "fuel cost adjustment proceeding" under which most utilities have recovered these costs since the early to mid 1970's, when the price and availability of fossil fuels became so volatile. The ECAC procedure involves, in part, a review of the prudence of the utility's prior year's expenses. To the extent that the Commission determines that any of the prior year's expenses were imprudently incurred, the Commission disallows those expenses and deducts them from the utility's otherwise authorized forecast energy expenses.[1]

Procedurally, this case arose out of the Commission's 1983 ECAC review of the prudence of the 1982 Tesoro Suspension Agreement. In the midst of that proceeding, intervenor City of San Diego (City) for the first time moved that the Commission review the prudence of the underlying Restated Agreement, arguing the Commission had specifically deferred a review of SDG&E's 1979 fuel costs, which would have included a review of the Restated Agreement, and had never subsequently undertaken that review. SDG&E objected that the Commission had already

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[1] In ECAC proceedings, the Commission staff or an intervenor will typically challenge the prudence of particular expenses, and the majority of hearing time will be devoted to an examination of these issues in an adversarial atmosphere. These reviews take place in a trial-like setting, differing from trials only in the presentation of direct testimony in written form in advance of hearings, and in a somewhat relaxed application of the rules of evidence. An Administrative Law Judge presides over hearings recorded by shorthand reporters where witnesses are sworn, the scope of allowed cross-examination is broad, and contested issues are subsequently fully briefed. The Judge then prepares a draft decision which the Commission may adopt or alter.

reviewed and approved the expenses the Company had incurred from January 1980 through June 1982 under the Restated Agreement in two prior ECAC proceedings, thereby approving the contract. The Administrative Law Judge (Judge), in consultation with the assigned Commissioner, nevertheless granted the City's motion.

The Commission's subsequent review of the Restated Agreement occurred in two phases, each resulting in a separate Commission decision. The first decision was the Interim Opinion (Decision 84-02-005, issued February 1, 1984), which made certain findings of imprudence with regard to SDG&E's entering the Restated Agreement. The second decision was the Final Opinion (Decision 84-12-026, issued December 5, 1984), which imposed a $45 million disallowance on SDG&E for the imprudence found in the Interim Opinion.

The Interim Opinion concluded that SDG&E's management had been imprudent in entering the Restated Agreement, and adopted verbatim the Judge's draft. The Commission determined as Conclusions of Law:

(1) ". . . the perceived benefits [of the Restated Agreement] did not outweigh the risks shown in [SDG&E's] own economic analysis;"

(2) "SDG&E . . . failed to conduct adequate studies before entering into the 1979 Restated Agreement;"

(3) SDG&E had "attempted to shield the shareholders from Commission penalties and the short-term carrying costs of excess LSFO inventory at the long-term expense of the ratepayers;" and

(4) SDG&E had "failed to adequately consider the possibility that greater quantities of natural gas than were forecast would become available despite

> its past experience in understating gas availability."

(Appendix, p. A-25.)

Another basis for the Commission's conclusion revealed in the Findings of Fact of the Interim Opinion was—

> (5) "The 1979 Restated Agreement eliminated the flexibility in contract volumes SDG&E had in the HIRI contract and substituted an inflexible take-or-pay obligation to Tesoro."

(Appendix, p. A-23 — A-24, Finding 14.)

As a consequence of the foregoing, the Commission determined that the issue of the reasonableness of SDG&E's payment of $45 million under the subsequent Suspension Agreement was "moot." Still, the Commission was unsure what amount to disallow from SDG&E's rates for SDG&E's imprudence, and in a section of its decision entitled "*Measure of Damages*", ordered a second phase of hearings for the purpose of receiving SDG&E's and staff's—

> . . . calculation of the actual consequences of the 1979 Restated Agreement. . . . From this calculation, we will determine an appropriate disallowance. In making the ratepayer whole for the consequences of SDG&E's decision to enter into the 1979 Restated Agreement, we will consider the financial impact of a disallowance on SDG&E since the ratepayer ultimately may bear some of that impact." (Appendix, p. A-22.)

In SDG&E's view, however, all that the Interim Opinion found consisted of procedural and motivational wrongdoing which said nothing objectively good or bad about the Restated Agreement. In other words, the Commission made no finding or conclusion, given the facts and circumstances known to anyone in 1978 and

1979, that some other course of action available to SDG&E, including maintenance of the status quo, would likely have led to lower costs or otherwise have been superior to SDG&E's entering the Restated Agreement.[2] Other than SDG&E's own evidence in support of its Restated Agreement, no evidence was offered on this critical issue.

Claiming a denial of due process under the California Constitution, and under the Fifth and Fourteenth Amendments of the United States Constitution, SDG&E applied for rehearing of the Interim Opinion. It based this claim on the Commission's failure to identify a superior alternative as mentioned above, and on the additional grounds of a lack of evidentiary support for the Commission's findings, which were in fact contrary to undisputed evidence; the inconsistency and contradictions of the findings and conclusions with previous Commission decisions approving the Restated Agreement; and the Commission's failure to judge the prudence of the Restated Agreement from the perspective of facts and circumstances known at the time the contract was entered. Before the Commission ruled on SDG&E's application for rehearing, the Commission held hearings on the second (or penalty) phase of its prudence inquiry.

In the second phase of hearings, SDG&E attempted to identify the conduct against which the Restated Agreement should be compared to calculate a disallowance, which the Interim Opinion failed to do. It offered the testimony of three nationally recognized energy economists, John O'Leary, William R. Hughes and Arlon R. Tussing. Each independently concluded that, even accepting the Interim Opinion's criticisms of inadequate procedures and improper motivations, each would have recommended in 1979 that SDG&E pursue a fuel strategy roughly comparable to that adopted

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[2] The pre-existing status quo cannot automatically be accepted as the natural alternative to any action being reviewed because the Commission does not presume the status quo is reasonable. It made that clear in Decision 82-04-115 when it told SDG&E it faced possible future disallowances if it did not alter the status quo of its fuel supply.

in the Restated Agreement. None of them believed that maintenance of the status quo would have been reasonable. They thus concluded there were virtually no negative "consequences" of the 1979 Restated Agreement. But because the Commission concluded that proffered testimony only attempted to "reargue" the reasonableness of the Restated Agreement, the Commission struck all of it.

The Final Opinion, issued after the second phase of hearings, reviewed several damage calculations presented by the parties. The details of these calculations are not relevant here, because the Commission declined to base its disallowance on any of them. The totality of the Commission's analysis of the "actual consequences" of the Restated Agreement and adoption of a disallowance is given at p. 31 of the Final Opinion (Appendix, p. A-57), where the Commission states:

> In reviewing the full range of figures developed in this record, we conclude that the only solid figure is the underlift penalty associated with the Suspension Agreement[3]. . . . [W]e know that from October 1, 1982 to December 31, 1983, SDG&E did not receive any LSFO from Tesoro and instead paid a $6.55/bbl underlift penalty, or a total of $45,060,000 in underlift penalties. This is the amount we will disallow.

SDG&E duly filed its Application for Rehearing of the Final Opinion on January 4, 1985, again arguing that it had been denied due process of law under the California Constitution and the Fifth and Fourteenth Amendments of the United States Constitution. In so doing, SDG&E argued the Final Opinion was subject to all the same federal constitutional infirmities as the Interim Opinion. On April 17, 1985, in Decision 85-04-111, the Commission

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[3] It was the reasonableness of this agreement which the Commission declared "moot" in its Interim Opinion. The Commission made no findings or conclusions respecting the prudence of this contract. (Appendix, p. A-21.)

modified the Final Opinion in several insubstantial respects and denied rehearing of it and the Interim Opinion. (Appendix, pp. A-67 — A-73.)

On May 21, 1985, SDG&E timely filed its Petition for Writ of Review of the three Commission decisions with the California Supreme Court, pursuant to Public Utilities Code Sections 1756, 1757, 1759 and 1760. SDG&E again claimed a denial, *inter alia*, of its federal constitutionally guaranteed right to due process of law by virtue of the Commission's decisions on all of the grounds SDG&E had previously asserted in its applications for rehearing of those decisions. On September 24, 1985, the California Supreme Court denied SDG&E's petition in a one line order (Appendix, p. A-74). SDG&E did not seek rehearing of that denial. On December 2, 1985, SDG&E filed its Notice of Appeal of that denial with that Court (Appendix, p. A-75).

THE QUESTIONS ARE SUBSTANTIAL

I.

THE DECISIONS BELOW RAISE RECURRING CONSTITUTIONAL ISSUES CONCERNING INCREASINGLY IMPORTANT REGULATORY REVIEWS OF MULTI-MILLION AND BILLION DOLLAR UTILITY ACTIONS.

This Court's attention to the due process issues in utility rate proceedings raised by this case is particularly important at this time, and these issues are ripe for review. This Court has not dealt with such issues for over 40 years, since *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942); and *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). Despite several opportunities, the California Supreme Court has declined to deal with these issues in the context of utility prudence reviews. The sole means California provides for review of Public Utilities Commission decisions is a discretionary petition for

Writ of Review to the California Supreme Court. That discretion has rarely been exercised, however, and the due process limitations on the Commission's exercise of its authority in the area of prudence reviews is accordingly not well defined. Given the nearly $12 billion currently subject to such review by the California Commission (Appendix, p. 78), the issues appellant presents here are especially ripe for this Court's consideration.

This appeal presents the Court with an opportunity to reaffirm the importance of due process requirements in a type of utility rate proceeding which is now surpassing, both in frequency and in dollar magnitude, the importance of general rate proceedings. These are the prudence reviews that occur in fuel cost adjustment proceedings like ECAC and in major plant addition applications. In the first type of case, utilities are essentially guaranteed dollar-for-dollar recovery of their fuel costs, *if they are found prudent*. In the late 1970s and early 1980s, SDG&E recovered over half its total revenues in such proceedings. For the second category of cases, utilities are allowed to add their investment in new plant to rate base, again, *if the investments are found prudent*. Today, these investments often consist of multi-billion dollar nuclear facilities.

Although the rate impact of these proceedings can often equal or exceed that of general rate cases, they are different from general rate proceedings and are quasi-judicial instead of quasi-legislative in nature. A commission reviews expenditures the utility has already made, and in the case of fuel offset cases, has sometimes already recovered in its rates. Rate of return is not at issue, nor the reasonably expected level of the utility's future expenses, to which level it will be held. In these cases, the utility is nearly always entitled to either total recovery of its actual expenses or total inclusion in rate base of its plant investment *if the expenditures are found to have been prudent*.

A recent survey shows that utility prudence reviews are increasingly common occurrences. Of state electric and gas utility cases reported in the Public Utility Reports Digest making significant

use of the "prudent investment test"[4], five such cases were found from 1944-1953, one from 1954-1963, three from 1964-1973, and *42* from 1974-1983. And as mentioned above, the California Commission alone is reviewing or is about to review nearly $12 billion in energy and new plant expenditures. (See Appendix, p. A-78 for an itemization.) On a national level, the amount under scrutiny is many times greater.

Due process in the conduct of these reviews is especially important today. The cost of all energy has increased enormously over the last decade. Not only have the costs of fossil fuels risen dramatically, but the capital costs of nuclear plants that were thought to offer lower cost alternatives to fossil fuels have also risen dramatically. Nuclear plants that were expected to cost $400 to $500 million have actually cost eight to ten times that amount. Neither consumers nor regulatory commissions have accepted these shocks to their expectations with equanimity. The pressure on commissions is great to ferret out all conceivable excesses in these purchases and investments in order to lower utilities' rate base and provide some respite to ratepayers who can find little relief in the reality of today's energy costs.

But the costs of any commission's failure to exercise its regulatory authority in a constitutionally scrupulous manner is great to all of society. Monday morning quarter-backing of a utility's fuel costs and investments by a commission is most likely to occur with long-term decisions where the probability is the greatest that events will turn out differently than expected. If utilities are usually penalized when their predictions turn out to be wrong though, management will cut its risks by only making shorter term "safe" decisions, even when circumstances at the time indicate a longer term decision is more likely to benefit ratepayers. And utilities who are denied the opportunity to earn a fair return on their new

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[4] This survey was prepared by the National Regulatory Research Institute (NRRI) with funding provided by participating member commissions of the National Association of Regulatory Utility Commissioners (NARUC). *The Prudent Investment Test In The 1980s*, NRRI (April, 1985).

plant additions, because they are only allowed to earn on less than their full investment, will be considered riskier investments for stock and bondholders, who will demand a greater return. In each instance, rates can increase for millions of users.

Disallowances for imprudence, when made, must be accepted by utilities and their equity holders, as well as their ratepayers, as *fair* regulatory assessments, not arbitrary action. Otherwise, utilities will actually be driven away from prudent decision-making toward mere risk reduction. The Supreme Court should reaffirm the requirements for due process in state utility prudence reviews.

II.

IT IS CONSTITUTIONALLY IMPERMISSIBLE TO JUDGE THE PRUDENCE OF A UTILITY'S ACTION FROM THE PERSPECTIVE OF HINDSIGHT.

A constitutional failing of the decisions below is that, both in particular findings and overall, they judge the prudence of SDG&E's Restated Agreement from the perspective of 20-20 hindsight, and not from the perspective of facts and circumstances known in 1978-1979. A hindsight-based reasonableness review denies a fundamentally fair hearing required by the due process clause, because it judges only a utility's fortune-telling ability, and not its "ability to govern and discipline [it]self by the use of reason," involving its "skill and good judgment in the use of resources." (*Prudence*, as defined by *Webster's New Collegiate Dictionary*.) In other words, a prudence review based on hindsight cannot constitute a prudence review at all and would constitute arbitrary state action.

Appellant has discovered no regulatory commission that has considered this issue which has concluded prudence can be determined other than by the commission's putting itself in the shoes the utility was wearing *at the time* it considered and undertook the action being scrutinized. Among the commissions adopting a

forward-looking, and rejecting a hindsight, prudence analysis are Maine, Michigan, Missouri, Montana, New Jersey, New York, Pennsylvania, Texas and the Federal Energy Regulatory Commission (FERC). The California Public Utilities Commission has itself recognized the essential soundness of this proposition in a number of its own decisions, stating that the reasonableness of management's actions must be determined in the context of the information and circumstances which existed at the time the decisions were made. (Decision 90404, 1 Cal. P.U.C. 2d 596, 623 (1979); Decision 92304, 4 Cal. P.U.C. 2d 386, 392 (1980); Decision 82-08-018, 9 Cal. P.U.C. 2d 551, 572 (1982).) The problem here, then, is not with the applicable standard, but with its implementation.

The hindsight basis of the Commission's imprudence finding is revealed by reference to two earlier Commission ECAC proceedings which reviewed the reasonableness of the Restated Agreement closer in time to the execution of that contract, and for periods when the contract was generating more benefits than costs. In late 1981, the Commission reviewed the reasonableness of SDG&E's fuel and related expenses, including those incurred under the Restated Agreement, for the period January 1980 through June 1981. The Commission staff prepared a written report analyzing the Restated Agreement and concluded it was "*very favorable* to both the utility and the ratepayers for a number of reasons." (Emphasis added.) Moreover, there was *no* evidence to the contrary. The Commission's decision in that case (Decision 82-04-115) made a Finding of Fact that:

> 12. SDG&E's operations and expenses for the period January 1980 through June 30, 1981 were reasonable. (9 Cal. P.U.C. 2d 1, 24.)

In late 1982 the Commission reviewed the prudence of SDG&E's fuel and related expenses, including expenses incurred under the Restated Agreement, for July 1981 through June 1982. This review was conducted at a time by which both the company and

the Commission knew the continuing availability of natural gas meant SDG&E had more oil under contract than was desirable. Nevertheless, the Commission decided in its Findings of Fact in Decision 82-12-056 that:

> 12. . . . SDG&E's operations and expenses for the period July 1, 1981 through June 30, 1982 were generally reasonable. . . . (10 Cal. P.U.C. 2d 351, 376)

The Commission never explains in its Interim Opinion, however, what happened *after* June 1982 to make the Restated Agreement unreasonable *from its inception*. Only hindsight can be used to answer that question.

Another clear example of the hindsight nature of the Commission's imprudence determination concerns its findings in the Interim Opinion that SDG&E had placed too great a reliance on its gas forecasts of 1978, which had shown that the availability of powerplant gas past 1981 was very questionable. These forecasts had led SDG&E to contract in the Restated Agreement for a relatively reliable future oil supply. The Commission concluded that SDG&E should have considered the "possibility" that more gas than forecast would actually have become available because--and for this reason alone--SDG&E had under-forecast gas availability over the previous several years.

There was little question in 1978 and 1979 as to the certainty of future gas supplies: it was highly questionable, especially for low priority users such as powerplants. This was clearer to no one than the Commission itself. In three decisions[5] the Commission rendered in 1978 alone, the Commission found that gas supplies in general, and powerplant supplies in particular, could be in short supply by as early as 1981, and almost certainly by 1982 and 1983.

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[5] *In re Natural Gas Supply Adjustment Mechanism*, 84 Cal. P.U.C. 5, 8, 14; *In re Western LNG Terminal Associates*, 84 Cal. P.U.C. 181, mimeo, p. A-310; *Southern California Gas Company*, 84 Cal. P.U.C. 657, 689.

Even in 1980, after SDG&E signed the Restated Agreement, a Commission staff forecast for California's gas distribution utilities predicted an average-year powerplant gas level of only 4 percent for 1982 and 0 percent for 1983.[6]

In fact, in a decision the Commission rendered only days after SDG&E signed the Restated Agreement, the Commission specifically rejected the very criticism it leveled at SDG&E in the Interim Opinion! In the proceeding leading to Decision 90404, issued June 6, 1979, the Commission staff had argued SDG&E was imprudent to continue to place virtually full reliance on the powerplant gas forecasts of its supplier when those forecasts regularly underestimated gas availability. Answering this criticism in Decision 90404, the Commission noted the conclusion of consultants, whom the Commission had ordered SDG&E to retain to evaluate its fuel planning and purchasing practices, and who said:

> . . . "[i]t was not possible to foresee or plan for the large quantities of interruptible P-5 gas becoming available that forced oil sales. . . ." (1 Cal. P.U.C. 2d 596, 625.)

In light of Southern California Edison's and Pacific Gas and Electric Company's also having overestimated their fuel oil requirements (by underestimating their gas supplies), the Commission then concluded:

> . . . it is unlikely that an effort more independent of SoCal (SDG&E's gas supplier) by SDG&E would have yielded a much different result. Moreover, if it did, SDG&E would have had to accept not only exposure to the risks and criticism of second guessing its supplier but to departing from "available information and historic state and nationwide

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[6] Report No. 2, "Report of Forecast of Natural Gas Supply, Requirements and Costs 1980 - 1989 for California Distribution Utilities, published by CPUC Staff.

> trends." (Decision 90404, 1 Cal. P.U.C. 2d 596 at p. 625.)

What could have caused the Commission to so change its view from 1978-1980 to 1984? Only its then-perfect knowledge that the forecasts of that time, including its own, were wrong.

III.

THERE IS NO SUBSTANTIAL EVIDENCE SUPPORTING THE COMMISSION'S FINDING OF IMPRUDENCE.

This Court has held in various administrative circumstances that to meet the requirements of due process, an agency must make findings that support its decision, and those findings must be supported by substantial evidence. *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962); *Interstate Commerce Commission v. J-T Transport Co.*, 368 U.S. 81, 93 (1961). For courts to be able to determine whether an agency has exercised its authority within legal bounds, the agency must "disclose the basis of its order." *Phelps Dodge Corp. v. National Labor Relations Board*, 313 U.S. 177, 197 (1941). The Court has interpreted "substantial evidence" to consist of—

> [M]ore than a mere scintilla. It means such relevant evidence as a reasonable mind might accept as adequate to support a conclusion. (*Consolidated Edison Co. v. National Labor Relations Board*, 305 U.S. 197, 229 (1938).)

An order which is based on a finding without evidence, or on evidence which clearly does not support it, is an arbitrary act and a denial of due process. *Northern Pacific Railway Co. v. Department of Public Works*, 268 U.S. 39 (1925).

While the Commission criticized SDG&E on five or six specific grounds in the Interim Opinion, its conclusion that the Restated

Agreement was unreasonable is based on only three: 1) giving up HIRI contract "flexibility" for the inflexible Restated Agreement, 2) SDG&E's own analysis purportedly showing the risks of the Restated Agreement were not outweighed by its benefits, and 3) SDG&E's attempt to shield its shareholders from Commission penalties.[7] Since these are the Commission's stated grounds, its imprudence finding must be judged solely by their adequacy and propriety. *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168-169 (1962); *Securities & Exchange Commission v. Chenery Corp.*, 318 U.S. 80 (1943). For an agency's order must be upheld, if at all, on the same basis articulated by the agency itself. A court will not attempt to sustain an agency's order by substituting what it considers to be an adequate basis for the ruling.

Accordingly, appellant restricts its discussion of evidentiary shortcomings to these grounds, and deals with the first two grounds in more detail below. The third ground, however, even if supported by evidence, is irrelevant to an imprudence finding and appellant does not separately discuss it; an attempt by SDG&E to shield its shareholders from Commission penalties says even less than the other two grounds about whether the Restated Agreement was unfavorable to ratepayers.

A. The Evidence Does Not Support The Finding Of Flexibility In The HIRI Contract.

At the time SDG&E negotiated and executed the Restated Agreement with Tesoro, it was purchasing LSFO from HIRI

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[7] The Final Opinion (Appendix, p. A-60) states that the "primary finding" of the Interim Opinion that the Restated Agreement was unreasonable was "not dependent on the latter discussion [in the Interim Opinion] which identifies additional conduct by SDG&E that was unreasonable." A review of the Interim Opinion shows the Commission concluded by the middle of p. 18 (Appendix, p. A-18) that SDG&E had been "unreasonable in signing the agreement based upon the information available to SDG&E at the time it entered into the Agreement." The Commission's conclusion, then, must be based on the criticisms of SDG&E it discusses *before* reaching that conclusion. Those are the three findings listed above.

pursuant to Amendment No. 7 of their original agreement. This amendment provided that SDG&E would purchase from HIRI from 1981 through the termination of the contract in 1984 the volume of 14,000 barrels per day (14 MBD), unless SDG&E opted to purchase the higher volume of 28.8 MBD. SDG&E was obligated to notify HIRI two years in advance if it wished to receive the higher volume. No provision was made for SDG&E's purchase of any other volumes in those years.

The Commission found in its Interim Opinion that SDG&E's substitution of the inflexible Restated Agreement for the "flexible" HIRI option to vary volumes "reflects extremely poor management judgment." (Appendix, p. A-16.) This conclusion was drawn solely from the Commission's interpretation of Amendment No. 7 to the HIRI agreement, which was never even discussed on the record, let alone introduced into evidence at the hearings. To this day, SDG&E does not know the source of the Commission's information about this document. Nevertheless, the Commission apparently read Amendment No. 7 or learned of its purported content outside of the hearings and briefs before it, found that it contained "flexibility" contrary to its plain and true meaning, and drew its conclusion critical of the Restated Agreement, all revealed for the first time in its Interim Opinion.

This Court stated long ago that "[n]othing can be treated as evidence which is not introduced as such." *United States v. Abilene & Southern Railway Co.*, 265 U.S. 274, 288 (1924). The commission there took judicial notice of information from annual reports filed by law with the commission, and used information from them as evidence of facts which it deemed necessary to prove, without notice of that intended use to parties. This Court found such use denied due process since it denied the carriers involved of notice of the evidence with which they were, in fact, confronted, as later disclosed in findings. SDG&E has as surely been denied due process here by the Commission's use of Amendment No. 7.

Further, the Commission concluded that Amendment No. 7 gave SDG&E the right to select *any* volumes from HIRI starting in 1981 between 14 MBD and 28.8 MBD, not just one or the other of those discrete volumes as is its correct meaning. The issue was never presented in the case and no evidence even remotely dealt with that amendment. The evidence supporting the Commission's finding cannot be known. This finding suffers the same due process infirmities identified by this Court in *Ohio Bell Telephone Co. v. Public Utilities Commission of Ohio*, 301 U.S. 292 (1937). There, the parties and the Court were entirely unable to determine the basis for a commission's finding of certain evidentiary facts which it withheld from the record and refused to disclose.

SDG&E argued against the Commission's interpretation in its Application for Rehearing of the Interim Opinion. The Judge then informed the Company he wished to examine an SDG&E witness on this issue in the penalty phase hearings on the Restated Agreement. From the Judge's cross-examination, the Commission altered its view of the "HIRI option" in its Final Opinion. It there concluded that HIRI contract flexibility adhered in SDG&E's supposed ability to *negotiate* volume changes to that contract, not in the contract itself (Appendix, pp. A-61 — A-62). No evidence was presented, however, that SDG&E could have negotiated the changes the Commission would have deemed an appropriate Restated Agreement substitute, nor did the Commission ever say what those revised HIRI volumes should have been.

The Commission's schizophrenic attitude toward the basis for its finding of HIRI contract "flexibility" underscores the lack of any evidence for it. In short, the Commission had no evidence from which to draw *any* conclusions about HIRI Amendment No. 7. In doing so, it has denied SDG&E due process of law under the federal Constitution.

B. The Commission's Finding That SDG&E's Own Analysis Showed The Benefits Did Not Outweigh The Risks Of The Restated Agreement Is Contrary To Undisputed Evidence.

In *Ohio Utilities Co. v. Public Utilities Commission of Ohio*, 267 U.S. 359 (1925), this Court rejected on due process grounds a commission finding of utility management imprudence that was not only without evidence, but also contrary to undisputed evidence. In the Interim Opinion, the California Commission concluded that the $500,000's worth of benefits which the company expected from Restated Agreement volume reductions in 1979 and 1980 were not equal to the risks of excess oil it created in 1981-1983, *according to SDG&E's own analysis*. This finding, too, is without supporting evidence and contrary to undisputed evidence.

This finding denies SDG&E due process. It is contrary to uncontradicted testimony that the $500,000 represented the net present value of the Restated Agreement *for its entire period* compared to what it replaced. This is apparent from a reading of the analysis in which it was contained and from the uncontradicted testimony of the witness who sponsored the analysis at hearings. No one ever argued, let alone presented evidence, that the $500,000 benefit was deemed to be restricted to the early years' effects of that contract.

Furthermore, the Commission ignores uncontradicted record evidence that the Restated Agreement gave the company the additional benefit of a reliable, domestic supply of fuel oil in years when gas was expected to be in short supply. This is opposed to the Commission's unsupported conclusion that SDG&E should have established a greater reliance on HIRI-supplied oil, which the evidence showed without contradiction was subject to interruption and more costly than Tesoro oil.

For the reasons stated above, the Commission's conclusion that the Restated Agreement was unreasonable is unsupported by any evidence and is contrary to undisputed record evidence. This

conclusion deprives SDG&E of due process of law and cannot therefore serve as a basis on which to assess any disallowance against SDG&E.

IV.

SDG&E WAS DENIED DUE PROCESS WHEN THE COMMISSION FAILED TO FIND THAT ANY ALTERNATIVE ACTION TO THE RESTATED AGREEMENT WOULD HAVE AVOIDED THE DISALLOWED EXPENSES, AND THE COMMISSION REJECTED SDG&E'S EVIDENCE ON THIS ISSUE.

A public utility is entitled to recovery of its reasonably incurred expenses. *West Ohio Gas Co. v. Public Utilities Commission of Ohio (No. 1)*, 294 U.S. 63, 72 (1935); *Southwestern Bell Telephone Co. v. Public Service Commission of Missouri*, 262 U.S. 276, 289 (1922). The California Public Utilities Commission acknowledges this precept:

> Regulatory law is well-settled that the Commission may disallow for ratemaking purposes any unreasonable expense if it is supported by findings of fact and conclusions of law. *If the Commission disallowed an expense it found to be reasonable, that action would be a confiscation of stockholder property*. [Emphasis added.] (Decision 82-12-054, 10 Cal. P.U.C. 2d 82, 121-122.)

This Court has also recognized that a simple but fundamental rule of—

> . . . administrative law . . . is to the effect that a reviewing court, in dealing with a determination . . . which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the

> agency. (*Securities & Exchange Commission v. Chenery Corp.*, 332 U.S. 194, 196 (1947).)

If those grounds are inadequate, the court is powerless to affirm the administrative action by substituting what it considers to be a more adequate basis. The Commission here has stated that its basis for determination of a disallowance would be ratepayer damages measured by the "actual consequences" of the Restated Agreement. This standard is as unmistakably clear as the kind of factual analysis it requires: that "but for" the allegedly imprudent action, the expenses to be disallowed would have been avoided. *See Bell v. Burson*, 402 U.S. 535, 541 (1971).

In *Albermarle Paper Co. v. Moody*, 422 U.S. 405 (1975), at pp. 418-419, the Court repeated the means by which damages are measured for an economic injury:

> [t]he general rule is, that when a wrong has been done, and the law gives a remedy, the compensation shall be equal to the injury. The latter is the standard by which the former is to be measured. The injured party is to be placed, as near as may be, in the situation he would have occupied if the wrong had not been committed. (*Wicker v. Hoppock*, 73 U.S. (6 Wall) 94, 99 (1867).)

Obviously, if the injured party would be in the same position if the wrong *had not been* committed as if it *had*, he would *not* be entitled to compensation. This test thus precludes the Commission from disallowing expenses claimed to have been imprudently incurred unless it finds that some more prudent action would have avoided them. It is insufficient as a basis for disallowance that the Commission merely find imperfections in the process by which SDG&E incurred those costs. The prudence of the process says nothing about whether the decision it led to was favorable or unfavorable to ratepayers. Where the Commission declares, as here, that the disallowance shall be measured by ratepayer damages, its failure to identify the more prudent action, against which the challenged action must be measured, necessarily precludes any determination or

calculation of ratepayer damages. For example, even where one has been negligent but his conduct has not injured another party, no one is entitled to compensation because there is no "actual detriment" to support an award of damages. *See, e.g., Story Parchment Co. v. Paterson Parchment Paper Co.*, 282 U.S. 555, 562 (1931); *Nelson v. Black*, 43 Cal.2d 612, 613-614, 275 P.2d 473, 474 (1954); *Gagne v. Bertran*, 43 Cal.2d 481, 492, 275 P.2d 15, 22-23 (1954); *Graeber v. Derwin*, 43 Cal. 495 (1872).

The Commission has failed to establish the fact of damage here. Even if it found "imprudence," it has failed to find, and took no evidence from which it could find, that some other action on the part of SDG&E in 1978-1979, including maintenance of the *status quo* (see footnote No. 2), would have avoided the expenses under the Restated Agreement which it ordered the Company to refund to its ratepayers.

Furthermore, the Commission improperly rejected the testimony of SDG&E's highly qualified outside consultants which went to the issue of the fact and extent of damages. And while this evidence would have tended to discount the likelihood that SDG&E's action did disadvantage its ratepayers, and was probably the reason the Commission rejected it, it is the only evidence anyone offered which attempted to address the issue of what SDG&E should have done in 1979 with respect to its existing fuel supply status.[8]

This appeal has a parallel in *West Ohio Gas Co. v. Public Utilities Commission of Ohio*, 294 U.S. 63 (1935). The utility there offered uncontradicted evidence that a nine per cent system gas loss was unavoidable with the most prudent of operations. The

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[8] Lest anyone suggest the Commission staff's phase two testimony did that, even the Commission had to acknowledge that staff's proposed disallowance did not attempt to limit itself to the allegedly deleterious effects of the Restated Agreement: "We agree that staff has calculated 'credits' and 'penalties' on LSFO quantities which exceed the volume changes negotiated in the [Restated] Agreement." Final Opinion, Appendix, p. A-51.

Ohio commission concluded, however, that more prudent management could reduce the loss to seven per cent, the amount it allowed in rates. No evidence supported the Commission's conclusion, however, and this Court held that without evidence that better utility performance would lower its costs, the utility was entitled to recovery of the full nine per cent loss.

The California Commission nevertheless denies the need for determining the appropriate alternative to SDG&E's execution of the Restated Agreement. In its Final Opinion, it said:

> SDG&E also argues that since the Interim Opinion did not describe an alternative course of action, the Commission has not yet determined that the Agreement was unreasonable, just SDG&E's procedures and motivations. There are *many* reasonable courses of action that SDG&E could have followed in 1979. The Agreement was not one of them. [Emphasis in original.] (Appendix, p. A-60.)

The statement also serves as a succinct acknowledgement that the Commission has failed to make *the* essential finding for imposing a disallowance. In nevertheless ordering the ratepayer refund, and in refusing to hear SDG&E's evidence on this essential issue, the Commission has denied SDG&E the due process of law to which it is entitled under the United States Constitution.

V.

THE COMMISSION'S $45 MILLION DISALLOWANCE IS FUNDAMENTALLY UNFAIR IN LIGHT OF ITS PRIOR APPROVAL OF THE RESTATED AGREEMENT AND ITS FAILURE TO PROVIDE SDG&E ANY OPPORTUNITY TO MITIGATE ITS COSTS THEREUNDER.

SDG&E's 1979 Restated Agreement should fairly have been reviewed by the Commission shortly after its signing. However,

the Commission had previously decided to delay its review of the reasonableness of California utilities' operations and expenses at this time because of its pending generic review of the ECAC mechanism. Although reasonableness reviews were temporarily in hiatus, the Commission specifically authorized parties to raise and develop reasonableness issues for future determination.

The Commission's final decision in its generic investigation was issued in December of 1980. It determined that the period subject to reasonableness review for SDG&E's initial application under the revised ECAC procedure was January 1980 through June 1981. The Commission further stated that the only issues prior to this period which would be subject to review were those that had been specifically identified and carried forward by prior decisions. Neither the Restated Agreement nor its associated fuel costs had been so identified.

The Commission's decision on SDG&E's first ECAC fuel cost application was not issued until April of 1982. That decision (Decision 82-04-115) found SDG&E's operations and expenses for that intitial January 1980 through June 1981 review period to be reasonable.

In spite of this finding, the Commission clearly stated in its April 1982 decision that, if SDG&E did not soon solve its then-existing fuel oil oversupply, it would consider imposing a penalty. In addition, the Commission issued an Order to Show Cause (OSC) why it should not simply order SDG&E to cease accepting oil from Tesoro. The Restated Agreement contained a *force majeure* provision which may have given the Commission the right to suspend the contract. SDG&E responded to the Commission's prodding by negotiating the Suspension Agreement with Tesoro in August of 1982, only four months after the Commission's direction to eliminate its oil oversupply in the near future.

Upon learning of the details of the Suspension Agreement, including SDG&E's obligation to pay Tesoro $45 million for

terminating the sale of all remaining Restated Agreement volumes, the Commission terminated its OSC. This action was necessary as a condition precedent to effectuation of the Suspension Agreement. The Commission simultaneously deferred the reasonableness review of the Suspension Agreement and its costs to a future proceeding. It was during this deferred review, which ultimately took place more than one year later, in late 1983, that the Commission decided that SDG&E's actions in *1979* had been imprudent.

SDG&E submits that the Commission must, for the sake of fundamental fairness, be estopped from asserting now that SDG&E's actions in 1979 were imprudent. The Commission's action is not only a reversal of its prior determinations made closer in time to the events being judged, but it also comes at a time when SDG&E, through direct compliance with Commission orders, and as a direct result of the Commission's actions, has been denied any opportunity to mitigate the damages now deemed to have occurred.

This Court said in *Dickerson v. Colgrove*, 100 U.S. (10 Otto) 578, 580 (1879):

> The vital principle is that he who by his language or conduct leads another to do what he would not otherwise have done, shall not subject such person to loss or injury by disappointing the expectations upon which he acted. Such a change of position is sternly forbidden. It involves fraud and falsehood, and the law abhors both.

This principle of equitable estoppel has been favorably cited on numerous occasions by the California Supreme Court, including *Carpy v. Dowdell*, 115 Cal. 677, 687 (1897); *Seymour v. Oelrichs*, 156 Cal. 782, 795; 106 P. 88, 94 (1909); and *City of Long Beach v. Mansell*, 3 Cal.3d 462, 488; 476 P.2d 423, 442; 91 Cal.Rptr. 23, 42 (1970). Use of this principle in the *City of Long Beach* case is particularly germane here because the California Supreme Court ap-

plied the principle against the City of Long Beach and the State of California in favor of private property owners. Thus, the California Court was able to overcome the reservations expressed by this Court in *Heckler v. Community Health Services of Crawford County*, 467 U.S. 51 (1984), where the opinion indicated this Court doubted it would ever be presented with facts justifying an estoppel against the government.

SDG&E believes that equitable estoppel is based on the concepts embodied in fundamental fairness and due process. *Black's Law Dictionary* defines "equity" as denoting "the spirit and the habit of fairness, justness, and right dealing. . . ." Those characteristics are missing here.

It should be recalled that the Commission's own procedures denied SDG&E timely review of its 1979 Restated Agreement. When SDG&E's operations and expenses were thoroughly reviewed and discussed by the Commission three years after the signing of the Restated Agreement, the Commission explicitly found SDG&E's actions during the bulk of that period to be reasonable, and reserved judgment on none of SDG&E's prior actions. SDG&E was justifiably led to conclude that its actions prior to April 1982, including the signing of the Restated Agreement, were deemed reasonable, and only its subsequent activities were subject to future review.

With this understanding, SDG&E believed that the Suspension Agreement with Tesoro, negotiated in the summer of 1982, was a fair solution for its then-existing oil oversupply. The Commission's decision to terminate its pending OSC, thereby expressly making the Suspension Agreement operative, and ending any opportunity for the Commission to simply order the termination of the Restated Agreement at no cost to SDG&E, was the act which caused the incurrence of the very costs which the Commission now claims are the results of SDG&E's imprudence. Simply continuing the OSC would have forced some other resolution of the oversupply problem. Obviously, SDG&E might have

experienced very different costs if the Commission had rejected the Suspension Agreement, or had earlier stated that the Restated Agreement was unreasonable. The Commission took none of these actions but, in fact, acted contrarily.

The Supreme Court's explanation of why it would *not* estop certain NLRB action in *National Labor Relations Board v. Bell Aerospace Co.*, 416 U.S. 267 (1974), at 295, tells why it *should* estop the Commission's action here:

> Furthermore, this is not a case in which some new liability is sought to be imposed on individuals for past actions which were taken in good-faith reliance on Board pronouncements. Nor are fines or damages involved here. In any event, concern about such consequences is largely speculative. . . .

The Commission should be estopped from now assessing a disallowance against SDG&E.

CONCLUSION

The California Public Utilities Commission's decision ordering SDG&E to refund $45 million to its ratepayers is arbitrary. The California Supreme Court has exhibited no interest in reviewing this or other "prudence" cases. This Court's refusal to hear and reverse this decision will confirm the California Commission's power to capriciously disallow expenses, without constitutional constraints, which utilities are otherwise legally entitled to recover. Because appellant's case presents a representative example of how utility ratemaking has fundamentally changed since this Court ruled in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), the Court should take the opportunity appellant presents here to reaffirm the due process requirements in utility

ratemaking for not only the California Commission, but for utility commissions nationwide.

Dated: December 19, 1985

Respectfully submitted,

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SAN DIEGO GAS & ELECTRIC COMPANY

Supreme Court, U.S.
FILED
DEC 23 1985
JOSEPH F. SPANIOL, JR.
CLERK

No. 85-1080

IN THE

Supreme Court of the United States

October Term, 1985

SAN DIEGO GAS & ELECTRIC COMPANY,

Appellant,

v.

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,

Appellee.

ON APPEAL FROM THE SUPREME COURT OF CALIFORNIA

APPENDIX TO THE JURISDICTIONAL STATEMENT OF APPELLANT SAN DIEGO GAS & ELECTRIC COMPANY

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APP

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Public Utilities Commission
State of California

Decision 84-02-005

February 1, 1984

TO: ALL PARTIES OF RECORD IN A.83-07-16

The Administrative Law Judge's proposed decision was signed without change by the Commission and accordingly, a separate document will not be filed and served under AB 2570 in order to save the expense of reproduction and postage.

Mary Carlos
Chief Administrative Law Judge

MC:bg

Decision 84-02-005 February 1, 1984

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application for SAN DIEGO GAS & ELECTRIC COMPANY, for Authority to revise its Energy Cost Adjustment Clause Rate, to revise its Annual Energy Rate, and to revise its Electric Base Rates in Accordance with the Electrical Revenue Adjustment Mechanism established by Decision 93892.	Application 83-07-16 (Filed July 8, 1983)

Barton M. Myerson, Randall W. Childress, William L. Reed, and Jeffrey L. Guttero, Attorneys at Law, for San Diego Gas & Electric Company, applicant.

John W. Witt, City Attorney, by William J. Shaffran and *Steven A. McKinley*, Deputy City Attorneys, for the City of San Diego; *F. E. John* and T. D. Clarke, by Gay M. Phillips, Attorneys at Law, for Southern California Gas Company; *Allen R. Crown*, Attorney at Law, for California Farm Bureau Federation; and *Harry K. Winters*, for University of California; interested parties.

Richard Rosenberg, Attorney at Law, for the Commission staff.

INTERIM OPINION

I. Summary of Decision

In this interim opinion, we adjust San Diego Gas & Electric's (SDG&E) Energy Cost Adjustment Clause (ECAC) rate, Annual Energy Rate (AER), and Electric Revenue Adjustment Mechanism

(ERAM) rate. The calculated adjustments would produce a net reduction of revenue of $65.5 million. However, in Decision (D.) 83-11-091 issued November 22, 1983, we already have ordered SDG&E to lower its ECAC rate to reduce revenues by $38.9 million. That reduction was ordered to offset a rate increase allowed for SONGS Unit 2. Accordingly, at this time we pass through to the ratepayer only the remaining $26.6 million.

We find SDG&E to have been unreasonable in entering into the 1979 Restated Agreement with Tesoro. An appropriate disallowance will be determined after further hearings.

II. Introduction

Application (A.) 83-07-16 is SDG&E's ECAC and AER forecast for the period beginning November 1, 1983.

After SDG&E filed the application, the Commission issued D.83-08-048 in Order Instituting Investigation (OII) 82-04-02, which established a new 92% ECAC/8% AER split for SDG&E and ordered proportional inclusion of all energy costs in both the ECAC rate and the AER. The decision also set the interest rate for Bankers' Acceptances as SDG&E's carrying cost on oil in inventory.

On September 7, 1983, the Commission issued D.83-09-007 in A.82-02-40 and A.82-03-63, which adjusted SDG&E's ECAC rate and AER to reflect the ratemaking treatment of San Onofre Nuclear Generating Station (SONGS) Unit 2.

SDG&E modified its showing to reflect the effects of both D.83-08-048 and D.83-09-007.

A prehearing conference was held on August 15, 1983. Twenty-four days of evidentiary hearing were held from August 25, 1983 to November 28, 1983. SDG&E presented eleven witnesses, and staff presented five.

Opening briefs were due December 16, 1983 and reply briefs on December 23, 1983. Staff requested a one week extension of time which was granted. SDG&E and the City of San Diego (City) timely filed opening briefs on December 23, 1983. Staff filed its opening brief on the Tesoro Suspension Agreement on December 27, 1983. Staff filed a supplementary brief covering the forecast issues on January 3, 1984. SDG&E filed a reply brief on January 5, 1984.

III. Issues

The issues raised by A.83-07-16 are important and varied. The usual forecast issues, i.e., prediction of SDG&E's energy costs, for the period November 1, 1983 to October 31, 1984 must be addressed. This annual endeavor to estimate test year oil, gas, purchased power, nuclear, and other energy costs overshadows the biennial general rate proceedings since SDG&E's energy costs are most of the utility's total operating costs. In addition, the increase of the AER from 2% to 8% of SDG&E's energy costs quadrupled the amount of energy expense that is recovered through a base rate based on test year estimates. Consequently, the estimates of SDG&E's energy costs to be adopted in our forecast are more important than before.

A.83-07-16 also includes a reasonableness review of the period July 1, 1982 to April 30, 1983. SDG&E is required to come forward with percipient witnesses and show that the management of its energy expense in the review period was "prudent and reasonable." While the staff generally identifies several reasonableness issues, intervenors frequently develop and pursue their own issues through the hearing and briefing process. Thus, all of the reasonableness issues often are not well-defined until the proceeding has been submitted.

The Commission also held over from the prior reasonableness review proceeding for SDG&E, A.82-08-014, the matter of the Tesoro Suspension Agreement. Extensive hearings were held in

A.82-08-014 in which SD&GE [*sic*], staff, and Tesoro-Alaskan Petroleum Corporation (Tesoro) presented witnesses on the Tesoro Suspension Agreement. However, the Commission deferred a decision to this proceeding and directed the staff to investigate further the circumstances surrounding the negotiation of the Suspension Agreement so the Commission would know more about the negotiation process before ruling on the agreement.

During hearing on the present application, the City argued that not only the Suspension Agreement entered into in 1982 but also the underlying 1979 Restated Agreement between Tesoro and SDG&E was at issue. The City pointed out that prior Commission decisions expressly held the 1979 record period open for review by the staff or intervenors. (See D.91106, 2 CPUC 2d 572, 576-577, issued December 19, 1979 and D.91545, 3 CPUC 2d 503, issued April 15, 1980.) The City then requested that SDG&E provide a witness on the 1979 Restated Agreement. The presiding administrative law judge (ALJ) ruled in favor of the City and ordered SDG&E to present a witness and further testimony on the 1979 Restated Agreement. SDG&E filed a motion to overturn the ALJ's ruling but provided a witness under protest. We affirm the ALJ's ruling and consider the 1979 Restated Agreement to be within the scope of this reasonableness review as clearly stated in our prior decisions. Furthermore, we consider any discretionary action by utility management which directly affects energy expenses incurred in the record period to be within the scope of our reasonableness review even if the action was taken before the record period. SDG&E's motion to overturn the ALJ's ruling is denied.

In summary, the areas at issue in A.83-07-16 consist of (1) the appropriate forecast for the November 1, 1983 to October 31, 1984 period (forecast period), (2) the reasonableness review of the July 1, 1982 to April 30, 1983 period (record period), (3) the Tesoro Suspension Agreement, and (4) the 1979 Restated Agreement between SDG&E and Tesoro.

Despite the extended hearing schedule, evidence and testimony on the record period was not received. So, further hearings will be held for this Area (2). In this Interim Opinion, we will address the forecast issues and decide the reasonableness of the Tesoro Suspension Agreement as well as the 1979 Restated Agreement.

IV. ECAC/AER Forecast

As discussed earlier, SDG&E's forecast showing was adjusted several times throughout the proceeding to account for the effects of Commission decisions issued after the application was filed. The last update was received as Exhibit 43, which shows a net revenue reduction of $57.3 million. This estimated reduction is based upon an ECAC rate decrease of .311¢/kWh, an AER increase of .181¢/kWh, and an Electric Revenue Adjustment Mechanism (ERAM) rate decrease of .426¢/kWh.

The centerpiece of SDG&E's forecast presentation is Exhibit 4 which explains the forecast resource mix. The resource mix was developed in the following manner:

1. SDG&E's Economic Research & Forecasting Department devloped an *electric sales estimate* for the forecast period using an econometric model which estimates average use by customer type and customer additions by quarter. From this sales estimate, SDG&E derived a system energy requirement of 12,140 Gigawatthours (GWHR).

2. SDG&E's Electric Operations Department developed a *purchased energy estimate* based on historical trends and existing contracts with other utilities. (Also, see Exhibit 22.)

3. SDG&E's Nuclear Department developed an estimate of *SONGS generation* with the operator, Southern California Edison (SCE).

4. The above data then was entered into SDG&E's *production costing program* which accounts for unit heat rates, capacity factors, forced outages, spinning reserve requirements, planned maintenance, and resource additions in determining SDG&E's fossil generation requirements. This program is a computer simulation of SDG&E's system.

5. The *maximum* amount of *gas* available to *burn* is derived from the production costing program's prediction of fossil generation requirements.

6. SDG&E's Gas Planning Department then provides its prediction of the *level of service* SDG&E should expect from its supplier, the Southern California Gas Company (SoCal).

7. Next, any fossil generation requirements which cannot be met by burning gas are assumed to be met by *low sulfur residual oil* (*LSFO*) *burn unless* additional oil burn is required for inventory control.

8. SDG&E calculated its required *LSFO inventory* level using three methodologies and selected an average inventory level for the forecast period.

9. SDG&E considered the level of LSFO deliveries under its Hawaiian Independent Refinery Incorporated (*HIRI*) *contract* in the forecast period, determined that contract deliveries exceeded its LSFO requirements by 1-1.3 million barrels, and evaluated the most economic disposal method, i.e., burn, store, sell, underlift, etc. SDG&E decided that the projected excess should be burned.

10. Finally, SDG&E derived a *resource mix* with its production cost program *after* including the effect of the

LSFO inventory control burn which the program otherwise would not have projected. The resulting resource mix which includes SONGS Unit 2 generation is as follows:

Resource	GWHR	% of Total Mix
Purchased Energy	5,074.2	41.79
Nuclear Generation	1,335.3	11.00
Natural Gas	3,813.3	31.41
Diesel Oil	0.2	0.00
LSFO	1,918.7	15.80
Total	12,141.7	100.00

SDG&E did not include SONGS Unit 3 generation in the forecast resource mix as nuclear generation because the impact of that facility's commercial operation on the ECAC rate and the AER in the forecast period will be examined in the rate base offset proceedings. (Natural gas is used as the "avoided cost" proxy for the expected SONGS Unit 3 generation in the above resource mix.)

SDG&E's forecast process was examined throughout the hearing, sometimes in minute detail. SDG&E was required to supplement its original showing with additional testimony on its purchased power estimate, SONGS Unit 2 projected capacity factor, and HIRI contract obligations. The staff and the City were given ample opportunity to cross-examine SDG&E's witnesses, to conduct further discovery, and if desired to present additional witnesses. This time-consuming procedure was permitted in recognition of the increased importance of the forecast underlying the AER.

Only a few issues related to SDG&E's forecast emerged in the briefs submitted by the parties. First, SDG&E and staff disagree on the appropriate level of LSFO inventory. Second, SDG&E and staff differ on the predicted capacity factor for SONGS Unit 2. Last, staff contends that the HIRI contract and the related Chevron transportation agreement will impose excessive and unwarranted costs on the ratepayer; however, staff does not make a

specific proposal of disallowance or other Commission action. These differences when combined amount to a total difference of only $2.206 million or .4%. The AER portion of this difference is only $176,477. (Exhibit 47, p. 1.) We conclude that the parties essentially now agree that SDG&E's forecast resource mix is reasonable. Accordingly, we substantially adopt SDG&E's forecast resource mix.

Despite our adoption of SDG&E's forecast, we must emphasize that SDG&E's management of 92% of its energy costs in the forecast period will be subject to reasonableness review in a forthcoming proceeding. The purpose of the forecast and the derived AER is to predict as best we can what SDG&E's energy costs will be at this single point in time and to set a base rate for 8% of these costs in the AER. SDG&E will retain the difference between the AER revenue and 8% of its actual energy costs within its earnings cap limitation of ± 120 basis points. SDG&E should have some incentive to lower costs because the larger AER is in effect.

In choosing a forecast now, we are not in any way endorsing SDG&E's "plan of action" for the forecast period. Rather, we are troubled by several aspects of SDG&E's Fuel Management Plan as presented in its testimony. We will comment on several of our concerns now to alert SDG&E and the other parties that we intend to closely examine SDG&E's fuel management decisions in the next reasonableness review proceeding.

First, we are concerned with the constraints that the HIRI contract has placed on SDG&E. The contract forces SDG&E to burn volumes of LSFO beyond the volumes called for under Efficiency Dispatch of the utility's generation system. The contract also prevents SDG&E from switching to Incremental Cost Dispatch which is SDG&E's lowest cost dispatch method. Moreover, we are aware that HIRI is willing to negotiate an underlift of the contract volumes. Limited negotiations between SDG&E and HIRI have already occurred. Thus, SDG&E has an opportunity to reduce its

LSFO burn. Despite the foregoing, SDG&E insists that an underlift will not occur in the forecast period.

We question SDG&E's continuing belief that a long-term LSFO supply is the only "reasonable course of action." The alleged benefits of SDG&E's long-term LSFO contracts have failed to materialize while the cost of these agreements has been instrumental in SDG&E charging one of the three highest electric retail prices in the country. We expect SDG&E to aggressively pursue all available options in solving its LSFO oversupply problem as well as the associated Chevron transportation charges. We repeat that SDG&E's management in this area will be scrutinized and questioned.

Second, we remain concerned about SDG&E's calculation of an appropriate LSFO inventory. SDG&E's analysis again relies upon a worst case scenario. The analysis is based only upon the utility's ability to replenish its LSFO inventory in an emergency situation. No consideration was given by SDG&E to other resource options such as purchased power. While SDG&E maintains that the oil-order option is not the only option SDG&E management could choose, it is the only option SDG&E considered in determining its minimum winter and summer LSFO inventories. Furthermore, as pointed out by staff witness Danner, SDG&E's analysis does not attempt to arrange the schedule of oil deliveries to coincide with the required oil burn. Focusing only upon this single scheduling factor, Danner was able to derive an average LSFO inventory 400,000 barrels lower than SDG&E's. This limited study by Danner shows that affirmative action by SDG&E management can substantially reduce the level of SDG&E's LSFO inventory. We choose to adopt Danner's inventory level of 1,006,000 barrels because we are convinced that SDG&E's analysis does not adequately consider affirmative management action in an emergency situation.

Finally, we choose to adopt staff's capacity factor for SONGS Unit 2. The staff has used the same capacity factor that was used

to adjust SCE's ECAC rate and AER. We see no reason why a different number should be used for SDG&E.

In summary, we adopt SDG&E's entire forecast, apart from its requested LSFO inventory level and SONGS Unit 2 capacity factor. The ECAC rate decrease of .385¢/kWh and AER increase of .174¢/kWh are shown in Table 1. These rate adjustments combined with an ERAM rate decrease of .426¢/kWh amount to a net reduction of revenue of about $65.5 million as compared to SDG&E's request of $57.3 million. The difference of $8.2 million is due to our adoption of a lower LSFO inventory level ($1.4 million), SONGS Unit 2 capacity factor (.8 million), and the removal of Tesoro underlift payments ($6 million) from the total expenses. Recovery of the Tesoro underlift payments will be addressed in the next section of this decision.

Consistent with our recent decision in SDG&E's general rate case (D.83-12-065) the System Average Percentage Change Method will be used to allocate the revenue changes flowing from this decision among customer classes.

Table 1

ECAC-AER Derivation

	M$
Purchased Energy	200,527.0
Nuclear Generation	18,090.0
Natural Gas	217.269.3 [*sic*]
Diesel Oil	34.0
LSFO	114,680.0
Subtotal Fuel and Purchased Energy	550,600.3
Plus New Albion Resources	1,610.3
Plus Variable Wheeling Expenses	2,059.3
Underlift Payments (Chevron Transp.)	928.185
Carrying Cost of Oil In Inventory	4,175.98
Total Expenses	559,374.165
ECAC - 92%	514,624.195
AER - 8%	44,749.970
ECAC offset rate decrease	.320¢/kWh
ECAC balancing rate decrease	.065¢/kWh
ECAC rate decrease	.385¢/kWh
AER increase	.174¢/kWh
Adopted AER	.429¢/kWh

V. 1979 Restated Agreement

SDG&E entered into the original agreement with Tesoro in July, 1974. The original agreement provided SDG&E with maximum LSFO deliveries of 10,000 barrels/day (bbl/d) from 1975 to 1980 and 5,000 bbl/d in 1981. This agreement was executed after the Commission encouraged the electric utilities to enter into long-term contracts with LSFO suppliers. (D.81931 issued September 25, 1973, 75 CPUC 713.)

The original agreement was amended on February 5, 1976 (Amendment No. 1) and on January 16, 1978 (Amendment No. 3). After Amendment No. 3 took effect, the maximum contract volumes had doubled to 20,000 bbl/d from 1978 to 1980 and to 10,000 bbl/day in 1981.

On January 1, 1979, the Restated Agreement took effect. Under the Restated Agreement, SDG&E was obligated to receive 17,000 bbl/d in 1979 and 1980, 18,000 bbl/d in 1981, 16,000 bbl/d in 1982, and 7,000 bbl/d in 1983. The Restated Agreement lowered contract deliveries in 1979 and 1980 by 3,000 bbl/d but increased contract deliveries by 8,000 bbl/d in 1981, 16,000 bbl/d in 1982, and 7,000 bbl/d in 1983. This renegotiation increased SDG&E's total contract deliveries from Tesoro by 9,125,000 barrels.

SDG&E maintains that the Restated Agreement seemed reasonable in late 1978. At that time, SDG&E's oil inventories had reached maximum operating levels due to the unexpected availability of natural gas and purchased energy. In addition, the disposal cost of LSFO in the spot market exceeded the economic benefit of burning natural gas. Accordingly, SDG&E tried to negotiate a reduction of contract volumes with Tesoro so that the utility could burn available natural gas.

Tesoro was unwilling to negotiate any volume reductions unless SDG&E would agree to a long-term extension of the contract. SDG&E tried to evaluate the benefits of a short-term reduction in

LSFO deliveries against the risks of a contract extension beyond 1981.

SDG&E asserts that during this period the long-term outlook for natural gas as a powerplant fuel was very pessimistic. For example, the 1977-1980 California Gas Reports showed levels of service to P-5 customers to be below 20% in 1982-1983. SDG&E believed that little or no powerplant gas would be available in the early 1980's.

Because of these pessimistic gas availability forecasts, SDG&E's projections of long-term LSFO requirements were increased. These projections were revised in November, 1978 to perform an analysis of the contract changes being negotiated with Tesoro. The revised projections showed that SDG&E's LSFO requirements had a 75% probability of not exceeding 13.5 million barrels in 1979, 13.7 million barrels in 1980, 13.9 million barrels in 1981, 11.2 million barrels in 1982, and 9.9 million barrels in 1983. SDG&E claims the above forecasted requirements exceeded the contractual commitments the utility was considering at that time.

In the utility's view, the Restated Agreement enabled SDG&E to reduce its LSFO volumes in the short-term and to accept more natural gas as it became available in 1979 and 1980. In return for this short-term benefit, SDG&E exposed itself to what was then perceived as "a relatively insignificant possibility that LSFO supply would exceed requirements in 1982 and 1983."

In addition, SDG&E points out that HIRI, the utility's other supplier, had at times declared the possibility of a force majeure reduction of contract volumes. SDG&E asserts that the Restated Agreement gave SDG&E in Tesoro, a LSFO supplier dependent on domestic sources of crude in addition to HIRI, a supplier dependent on foreign sources.

SDG&E's fuel procurement strategy at that time was to depend on the sport market for no more than 5-10% of LSFO require-

ments. Thus, using the utility's November, 1978 revised projections of LSFO requirements, SDG&E's strategy called for a firm contract supply of 12.2-12.8 million barrels in 1979, 12.3-13.0 million barrels in 1980, 12.5-13.2 million barrels in 1981, 10.1-10.6 million barrels in 1982, and 8.9-9.4 million barrels in 1983. The balance of the forecast requirements could be obtained on the spot market or from other resources.

Under the Restated Agreement, SDG&E agreed to receive from Tesoro about 6.2 million barrels of LSFO in 1979 and 1980, 6.6 million barrels in 1981, 5.8 million barrels in 1982, and 2.6 million barrels in 1983.

SDG&E's witness Watkins testified that SDG&E's contract with HIRI provided 14,000 bbl/d through 1984. This is equivalent to 5.1 million barrels per year. A tabulation of these contract volumes shows that SDG&E's firm contract volumes with the Restated Agreement exceed 90-95% of its forecast LSFO requirements only in 1982.

Year	90-95% of Forecast LSFO Requirements	Restated Tesoro Volumes	HIRI Volumes
	(millions of barrels)		
1979	12.2-12.8	6.2	5.1
1980	12.3-13.0	6.2	5.1
1981	12.5-13.2	6.6	5.1
1982	10.1-10.6	5.8	5.1
1983	8.9- 9.4	2.6	5.1

However, Watkins neglected to mention that at the time negotiations with Tesoro were occurring, the HIRI contract volumes could have been increased at the utility's option from 14,000 bbl/d to 28,800 bbl/d upon two years' written notification. (Amendment No. 7 dated May 10, 1978.) Therefore, SDG&E could have relied upon a range of 5.1-10.5 million barrels from HIRI in 1981-1983. However, instead of relying upon the HIRI option, SDG&E chose to extend the Tesoro agreement from 1981 to 1983.

Another tabulation of SDG&E's contract volumes before the Restated Agreement shows that firm contract volumes did not exceed 90-95% of forecast LSFO requirements from 1979 to 1983.

Year	90-95% Forecast LSFO Requirements	Tesoro Volumes Before Restated Agreement	HIRI Volumes w/ Option to Increase Deliveries
	(millions of barrels)		
1979	12.2-12.8	7.3	5.1
1980	12.3-13.0	7.3	5.1
1981	12.5-13.2	3.65	5.1-10.5
1982	10.1-10.6	-	5.1-10.5
1983	8.9- 9.4	-	5.1-10.5

After comparing these tabulations, we conclude that although SDG&E was able to reduce contract volumes in 1979 and 1980 by entering into the Restated Agreement with Tesoro, these short-term reductions were more than offset by the increased volume obligations in 1981-1983. SDG&E paid a heavy price since it in effect substituted a flexible option to call upon HIRI to deliver increased volumes for the extension of an inflexible take-or-pay agreement with Tesoro. SDG&E would pay very dearly for this substitution. From these facts alone, we conclude that SDG&E's decision to enter into the Restated Agreement reflects extremely poor management judgment.

What benefits did SDG&E expect to receive under the Restated Agreement? SDG&E estimated at the time that just *$500,000* in fuel savings would result from the volume reductions in 1979 and 1980. This projected benefit does not equal the risk of excess LSFO in 1981-1983 that SDG&E assumed under the Restated Agreement.

SDG&E's own economic analysis of the Restated Agreement's benefits demonstrates that the modest fuel savings were not worth extension of the agreement. Watkins testified that in approving the Restated Agreement he had specifically relied upon Enclosure 1 of the utility's economic analysis. Enclosure 1 showed the probability that SDG&E would have excess LSFO under the Restated Agreement

in the years 1979-1983. After reviewing Enclosure 1, Watkins said the Restated Agreement reduced the risk of excess LSFO in 1979 by about 50% since the graph indicated an approximate 80% probability of excess LSFO without the Restated Agreement and only a 30% probability of excess LSFO with the Restated Agreement. Upon closer examination, the probability difference is about 40% rather than 50%. Nonetheless, we agree that the Restated Agreement substantially reduced the risk of excess LSFO in 1979 according to Enclosure 1. A similar analysis for 1980 shows that the Restated Agreement reduced the probability of excess LSFO in that year by about 10%. However, Enclosure 1 also shows that extension of the Tesoro Agreement through 1983 had the effect of *increasing* the probability of excess LSFO in 1981 by 15% and in 1982 by 35%. Thus, SDG&E's own probabilistic analysis in Enclosure 1 showed at best marginal benefits from the Restated Agreement. Clearly, Watkins and the rest of SDG&E's management were concerned only about a short-term solution to the LSFO oversupply problem. Inadequate consideration was given to the added risk of excess LSFO in later years that the Restated Agreement created.

Why did SDG&E enter into the Restated Agreement? We conclude after a careful review of the evidence and testimony that SDG&E was trying to avoid Commission assessment of a $1/bbl penalty for the rejection of available gas in 1979 and 1980. The memoranda attached as Appendix D to Exhibit 44 have several references to the possibility of a $1/bbl penalty.

> "In order to make the ratepayer indifferent as to whether fuel oil would be burned in preference to cheaper natural gas, a $1/bbl penalty *could* be levied by the CPUC for every barrel equivalent of gas rejected."

> "In order to make the ratepayer indifferent as to whether oil would be burned in preference to cheaper natural gas, a $1 penalty could be levied by

> the CPUC for every BBLR of natural gas rejected. A fifty-fifty chance of such a penalty was assumed." (Exhibit 44, App. D, pp. 1, 6.)

SDG&E apparently was preoccupied with the possibility of a Commission disallowance for rejected natural gas in 1979 and 1980 and entered into the Restated Agreement without adequate consideration of the possibility of excess LSFO in later years. We conclude that SDG&E was unreasonable in signing the Restated Agreement based upon the information available to SDG&E at the time it entered into the agreement.

The City in its brief takes SDG&E to task for entering into the Restated Agreement without conducting adequate studies. The City argues (1) SDG&E failed to study and analyze alternatives to the Restated Agreement, (2) SDG&E failed to analyze future trends in LSFO availability and prices, (3) SDG&E failed to analyze the Restated Agreement from the ratepayer's perspective, and (4) SDG&E chose to rely upon arbitrary and unreliable forecasts when evaluating the costs and benefits of the Restated Agreement. The City concludes that SDG&E was imprudent and unreasonable because the utility did not have sufficient information to enter into the Restated Agreement.

First, the City points out that in August, 1978, SDG&E had received the Gilbert Management Consultant's Report (Gilbert Report) introduced as Exhibit 2 in A.57780 and A.58263. The executive summary to this report is attached as Appendix A to D.90404, 1 CPUC 2d 596 (1979). The Gilbert Report found SDG&E's documentation and alternative studies in support of its fuel decisions to be deficient. The report further stated that more structured analysis and additional studies are needed to support SDG&E's actions.

The City argues that SDG&E failed to undertake the analysis recommended in the Gilbert Report. First, SDG&E did not study the contract and its terms to see if more favorable contract

provisions could be negotiated. The Gilbert Report had identified several unfavorable contract provisions which SDG&E did not even attempt to correct. Second, the utility's economic analysis did not analyze the alternatives of an underlift, sale, storage, or excess LSFO burn. The City asserts that each of these alternatives was a potential solution to the short-term LSFO oversupply. However, SDG&E chose to evaluate only the alternative of a contract extension. The City concludes that SDG&E was imprudent and unreasonable because it failed to comply with the Gilbert Report's recommendations.

Second, the City points out that SDG&E did not have forecasts of spot market LSFO availability when it decided to sign the Restated Agreement. The utility also did not have any estimates of spot market LSFO prices or contract prices for the years 1979-1983. The City maintains that without this forecast information SDG&E should not have entered into the Restated Agreement.

The City contends that the burden of any excess LSFO inventories in 1979 and 1980 would have been borne by SDG&E's shareholders since the carrying costs at that time were set in biennial general rate proceedings and were not recovered through ECAC. The City then points out that the two major costs examined by SDG&E were the carrying costs of excess LSFO inventory and the possible $1/bbl penalty for rejecting cheaper natural gas. Both costs analyzed by SDG&E were costs to the shareholder, not the ratepayer. The City argues that SDG&E never evaluated the reasonableness of the Restated Agreement from the ratepayer's perspective. For this reason, the City characterizes SDG&E's decision to sign the Restated Agreement as imprudent and unreasonable.

Finally, the City criticizes the gas forecast used by SDG&E in analyzing the Restated Agreement. The City point [*sic*] out that SDG&E's gas model had consistently understated the quantity of natural gas available for powerplant use in 1975, 1976, 1977, and

1978. In late 1978, SDG&E should have been well aware that its forecasting methodology was unreliable.

The City claims that SDG&E's inaccurate gas forecasts resulted in excess LSFO situations and oil sale losses totaling $11.3 million from 1976-1978. Despite this track record, SDG&E relied upon the same gas forecasting methodology to extend its contract with Tesoro. The City asserts that SDG&E's reliance upon a historically inaccurate gas forecasting methodology was imprudent and unreasonable.

In its reply brief, SDG&E responds to each of the City's arguments.

First, SDG&E argues that any analysis of the alternatives discussed in the City's brief would have been an idle act. The utility claims that none of the alternatives was a practical option in 1979.

Second, SDG&E contends that any long-term forecasts of LSFO availability and prices would have been useless information. The utility desired to reduce its contract volumes with Tesoro and had to agree to buy more oil from Tesoro in order to reduce volumes in 1979 and 1980. Furthermore, SDG&E maintains that any long-term forecasts of LSFO prices would have been too speculative.

Third, SDG&E maintains that its decision to enter into the Restated Agreement was based primarily upon ratepayer concerns. The purpose of the agreement was to lower short-term LSFO deliveries so that cheaper natural gas could be burned. The ratepayers would have received the short-term fuel savings of the Restated Agreement, not the shareholders.

Fourth, SDG&E asserts that it relied upon the best available gas forecasts when deciding to sign the Restated Agreement. The utility emphasizes that all gas forecasts at that time proved to be inaccurate. Moreover, SDG&E points out that the City has offered no other source of information which the utility could have turned to

back in 1979.

Despite SDG&E's protests, we are persuaded that the utility did not adequately study the long-term risks and liabilities posed by the Restated Agreement. Ignoring past experience, the utility chose to commit itself to long-term LSFO supplies without even considering the chance that despite pessimistic forecasts, natural gas or other alternative resources would become available. SDG&E chose instead to lock its resource mix into a take-or-pay LSFO contract through 1983 to avoid burdening its shareholders with the short-term carrying costs of excess LSFO inventory and a penalty for rejecting natural gas. Apparently, SDG&E's management also was unmoved by the Gilbert Report's recommendations which were known at that time. SDG&E's management was unreasonable in entering into the Restated Agreement.

VI. Tesoro Suspension Agreement

Since we have found the underlying 1979 Restated Agreement to be unreasonable, the issues raised by the 1982 Tesoro Suspension Agreement now are moot. Although we find that SDG&E produced a percipient witness on the 1982 issue and thus met its procedural burden of proof, our finding that the 1979 agreement was unreasonable eliminates the necessity to consider whether we would have found SDG&E's presentation on the 1982 contract adequate from a reasonableness perspective. However, the Suspension Agreement did mitigate the losses imposed by the Restated Agreement and will be considered in our eventual calculation of a disallowance.

Although we do not address the merits of staff's case attacking SDG&E's negotiation of the Suspension Agreement, we will state that SDG&E procedurally met its burden of proof on this matter. SDG&E provided all available documentation of its negotiation efforts and percipient witnesses to explain the transaction. The lack of more extensive documentation or the failure to call all possible percipient witnesses are matters left to SDG&E's judgment in the presentation of its case. This record is sufficient to

render a decision.

VII. Measure of Damages

We direct SDG&E and staff to prepare for the further hearings in this matter a calculation of the actual consequences of the 1979 Restated Agreement. For example, any realized fuel savings in 1979 and 1980 due to the lower contract volumes should be offset against the actual costs that accrued in 1981-1983 due to a less economical resource mix or from underlift payments. Other tangible costs or benefits may be used in the calculation.

From this calculation, we will determine an appropriate disallowance. In making the ratepayer whole for the consequences of SDG&E's decision to enter into the 1979 Restated Agreement, we will consider the financial impact of a disallowance on SDG&E since the ratepayer ultimately may bear some of that impact.

SDG&E and staff shall prepare and serve upon all parties testimony showing a calculation of the economic consequences of the Restated Agreement within 20 days from today.

Findings of Fact

1. In A.83-07-16, SDG&E requests adjustment of its ECAC rate, AER, and ERAM rate for a net revenue reduction of $57.3 million.

2. SDG&E's forecast resource mix is reasonable and should be adopted, apart from SONGS Unit 2 generation.

3. The staff's capacity factor for SONGS Unit 2 is consistent with the capacity factor adopted in D.83-09-025 for SCE.

4. SDG&E's calculation of an LSFO inventory does not adequately consider affirmative action by management in an emergency situation.

5. SDG&E's requested LSFO inventory level is excessive.

6. The staff's LSFO inventory level of 1,006,000 barrels is more reasonable than SDG&E's and should be adopted.

7. An ECAC rate decrease of .385¢/kWh, an AER increase of .174¢/kWh, and an ERAM rate decrease of .426¢/kWh are reasonable based on the adopted forecast and LSFO inventory level.

8. The above rate adjustments would produce a net revenue reduction of $65.5 million.

9. On November 22, 1983, the Commission issued D.83-11-091 in A.82-02-40 and A.82-03-63 which ordered SDG&E to reduce its ECAC rates by $38.9 million.

10. On December 12, 1983, SDG&E filed tariff schedules as ordered in D.83-11-091 which lowered its ECAC rate by .396¢/kWh.

11. Since an ECAC decrease of $38.9 million has already occurred, the net reduction of revenue of $65.5 million should be reduced by $38.9 million; SDG&E's ECAC rate should increase by .011¢/kWh rather than decrease by .385¢/kWh.

12. At the time SDG&E entered into the 1979 Restated Agreement, the utility had a long-term contract with HIRI for LSFO deliveries through 1984 with an option to increase deliveries in 1981, 1982, and 1983.

13. At the time SDG&E entered into the 1979 Restated Agreement, the utility projected fuel savings of just $500,000 from the agreement.

14. The 1979 Restated Agreement eliminated the flexibility in contract volumes SDG&E had in the HIRI contract and substi-

tuted an inflexible take-or-pay obligation to Tesoro.

15. The utility's economic analysis showed the 1979 Restated Agreement reduced the probability of excess LSFO in 1979 and 1980 but increased the probability of excess LSFO in 1981 and 1982.

16. At the time SDG&E entered into the 1979 Restated Agreement, the perceived benefits did not outweigh the risks shown in the utility's own analysis.

17. SDG&E was preoccupied with the possibility of a $1/bbl penalty for rejecting cheaper natural gas when it entered the 1979 Restated Agreement.

18. SDG&E entered into the 1979 Restated Aggreement [*sic*] to shield its shareholders from the carrying costs of an excess LSFO inventory in 1979 and 1980.

19. SDG&E did not conduct adequate studies before entering into the 1979 Restated Agreement.

20. SDG&E did not follow the recommendations of the Gilbert Report before entering into the 1979 Restated Agreement.

21. At the time SDG&E entered into the 1979 Restated Agreement, the utility had not considered the possibility that more natural gas would be available than was forecast even though the utility's gas forecasting methodology had consistently understated the volumes of natural gas that became available in 1975, 1976, 1977, and 1978.

21. Because the revision date of November 1, 1983 is past, this interim order should take effect on the date of issuance.

Conclusions of Law

1. SDG&E was unreasonable in entering the 1979 Restated Agreement with Tesoro because at that time the perceived benefits did not outweigh the risks shown in the utility's own economic analysis.

2. SDG&E was unreasonable because the utility failed to conduct adequate studies before entering into the 1979 Restated Agreement.

3. SDG&E was unreasonable because the utility attempted to shield the shareholders from Commission penalties and the short-term carrying costs of excess LSFO inventory at the long-term expense of the ratepayers.

4. SDG&E was unreasonable because the utility failed to adequately consider the possibility that greater quantities of natural gas than were forecast would become available despite its past experience in understating gas availability.

5. Further hearings should be held to determine the amount of any disallowance.

INTERIM ORDER

IT IS ORDERED that:

1. On or after the effective date of this interim order, SDG&E shall file, in conformance with the provisions of General Order 96-A, revised tariff schedules reflecting the following rate adjustments:

(a) ECAC rate increase of .011¢/kWh.
(b) AER increase of .174¢/kWh.
(c) ERAM rate decrease of .426¢/kWh.

The revised tariff schedules shall take effect 5 days after filing.

2. Consistent with our recent decision in SDG&E's general rate case (D.83-12-065) the System Average Percentage Change Method will be used to allocate the above revenue changes among customer classes.

3. SDG&E and staff shall prepare and serve on all parties testimony on the consequences of the 1979 Restated Agreement within 20 days from today. This testimony will be received as evidence in further hearings and will be the basis for determining an appropriate disallowance.

4. SDG&E's motion to overturn the ALJ's ruling on the 1979 Restated Agreement is denied.

This order is effective today.

Dated February 1, 1984, at San Francisco, California.

LEONARD M. GRIMES, JR.
President
VICTOR CALVO
PRISCILLA C. GREW
DONALD VIAL
WILLIAM T. BAGLEY
Commissioners

Decision 84-12-026 December 5, 1984

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SAN DIEGO GAS & ELECTRIC COMPANY, for authority to revise its Energy Cost Adjustment Clause Rate, to revise its Annual Energy Rate, and to revise its Electric Base Rates in accordance with the Electrical Revenue Adjustment Mechanism established by Decision 93892.	Application 83-07-16 (Filed July 8, 1983)

(See Decision 84-02-005 for appearances.)

Additional Appearances

Pillsbury, Madison & Sutro, by *Richard W. Odgers*, Attorney at Law, for San Diego Gas & Electric Company, applicant.

John W. Witt, City Attorney, by *Leslie J. Girard*, Deputy City Attorney, for the City of San Diego, interested party.

Rufus G. Thayer, Attorney at Law, for the Commission staff.

FINAL OPINION

I. SUMMARY OF DECISION

We order the San Diego Gas & Electric Company (SDG&E) to refund $45,060,000 to its ratepayers. In our interim opinion, Decision (D.) 84-02-005, we found that SDG&E's 1979 Restated Agreement (Agreement) with Tesoro-Alaskan Petroleum Corporation

(Tesoro) was unreasonable. This refund returns to the ratepayers some of the excessive fuel costs caused by the Agreement over the period July 1, 1982 to December 31, 1983. We do not disallow any expenses incurred over the January 1, 1979 to June 30, 1982 period to avoid adjustment of prior reported earnings for SDG&E.

We also grant the staff motion for disclosure and direct SDG&E to serve the documents which were the subject of the motion on all parties to this proceeding.

We deny SDG&E's motion to overturn the Administrative Law Judge's (ALJ's) evidentiary rulings. The ALJ properly excluded SDG&E prepared testimony which simply reargued the reasonableness of the Agreement. The ALJ also properly admitted staff testimony which sought to measure the actual consequences of the Agreement.

II. BACKGROUND

On February 1, 1984, the Commission issued an Interim Opinion, D.84-02-005, which found, inter alia, that SDG&E's Agreement with Tesoro was unreasonable. The Commission ordered that further hearings should be held to receive evidence on the actual consequences of the Agreement and the financial impact on SDG&E of a disallowance. The Commission wanted to consider this additional evidence before a disallowance is determined.

On February 3, 1984, the ALJ held a second Prehearing Conference (PHC) to schedule the further hearings ordered in D.84-02-005. At the start of this PHC, SDG&E made a motion to remove the ALJ as the assigned hearing officer for the proceeding. SDG&E presented a written Motion to Disqualify ALJ and asked that the PHC be continued until the motion was ruled upon. The ALJ denied SDG&E's request for a continuance and took the Motion to Disqualify ALJ under submission. A schedule was set for the mailing of prepared testimony and the further hearings. The ALJ also ordered SDG&E to disclose certain documents and other

information related to fuel procurement for the period 1975-1983.

On March 1, 1984, SDG&E filed a Motion For Establishment of 10 Day Rule (Rule 68) As Basis For Filing of Prepared Testimony In Penalty Phase Hearings. The ALJ instructed SDG&E to mail any completed testimony under the schedule set at the second PHC and to mail any additional testimony before the next PHC.

On March 2, 1984, SDG&E filed an Application For Rehearing of D.84-02-005. This application was referred to the Appellate Section of the Commission's Legal Division.

On March 5, 1984, the assigned Commissioner issued a ruling denying SDG&E's Motion To Disqualify ALJ. At the Commission's Meeting on March 7, 1984, the assigned Commissioner reported his ruling to the full Commission.

On March 19, 1984, the ALJ held a third PHC. At this PHC, the Commission staff asked for clarification on the scope of this phase of the proceeding. The staff argued that much of the testimony prepared by SDG&E for this phase of the proceeding relitigated issues already decided in the Interim Opinion, D.84-02-005. The staff then moved to exclude SDG&E's prepared testimony from this phase of the proceeding. The City of San Diego (City) joined in staff's motion. SDG&E responded that it was not attempting to relitigate D.84-02-005 in its prepared testimony and requested leave to submit by letter legal authorities supporting its position on the appropriate measure of damages. The ALJ allowed all parties to submit letters on the relevant legal authorities and took staff's motion under submission. In addition, the ALJ set a new hearing schedule to allow time for review of the parties' letters and a ruling on staff's motion.

On April 9, 1984, hearing was held to receive the testimony of two SDG&E witnesses: William A. Abrams and R. Lee Haney. Staff and City cross-examined these two witnesses.

On April 25, 1984, SDG&E filed a Petition Requesting Commission Ruling on Motion To Disqualify ALJ. In this petition, SDG&E requested that the full Commission approve or deny the assigned Commissioner's ruling issued March 5, 1984.

On May 2, 1984, the ALJ issued a ruling granting staff's and City's motion to exclude the prepared testimony of SDG&E witnesses John O'Leary, Arlon Tussing, and William Hughes. The ruling also excluded portions of SDG&E witness Michael Niggli's testimony. Staff had moved for the exclusion of Niggli's entire prepared testimony.

By letter dated May 21, 1984, SDG&E asked that the Commission defer a denial of its Application for Rehearing until after the Commission issues a decision on a disallowance. However, if the Commission was inclined to grant rehearing, then SDG&E said a deferral would be unnecessary. This request also was referred to the Appellate Section.

Additional hearings were held on May 22-24 and June 1, 1984. Testimony from SDG&E's remaining witness, Michael Niggli, and staff's witnesses, Russell Copeland and Ray Czahar, were received during these hearings. In addition, SDG&E witness Abrams sponsored some rebuttal testimony.

On May 22, 1984, the ALJ informed SDG&E that the full Commission at its March 7, 1984 Meeting already had confirmed the assigned Commissioner's ruling on SDG&E's Motion To Disqualify ALJ. Therefore, SDG&E's April 25, 1984 Petition Requesting Commission Ruling On Motion To Disqualify ALJ was moot. This is apparently in error since no minute order reflecting this action was entered. The ALJ further advised SDG&E that it must file an appeal of the assigned Commissioner's ruling if it intended to pursue this matter any further. No such appeal was filed nor was the matter raised in briefs. We hereby affirm the assigned Commissioner's ruling.

On the last day of hearing, June 1, 1984, SDG&E orally requested that the ALJ issue a proposed report pursuant to Rule 78. Rule 78 provides that a written petition for a proposed report shall be filed before the conclusion of hearing. However, staff and City did not object to SDG&E's oral request. At this time, SDG&E also stated that the company previously had given documents to Commissioners or their aides which had not been served upon the parties. Staff and City asked that these documents be produced and served upon the parties. The ALJ took this motion to compel discovery under submission.

Opening briefs were filed by SDG&E, staff, and City on July 9, 1984. Closing briefs were filed on July 23, 1984. The ALJ's Proposed Report was issued on September 14, 1984. Exceptions to the report were filed by SDG&E, staff, and City on October 4, 1984. Oral argument before the Commission en banc was held on October 29, 1984.

III. SUMMARY OF EVIDENCE

Additional evidence was received on two subjects: (1) the financial impact of a disallowance, and (2) disallowance calculations based on the actual consequences of the Agreement.

A. Financial Impact

1. SDG&E Evidence

SDG&E sponsored two witnesses on the financial impact of a disallowance: William Abrams and R. Lee Haney. Abrams is a vice president at Duff and Phelps, Inc., an investment research organization. Haney is a vice president and treasurer of SDG&E. Both witnesses testified that a disallowance based on the Agreement will have an adverse impact on SDG&E's credit rating and cost of capital.

Abrams explained how Duff and Phelps determines credit ratings and how SDG&E's credit rating would be affected by a disallowance. Abrams testified that credit ratings are based primarily on the financial integrity of the company. He stated that the stability and protection of the company's income stream are very important in measuring a company's financial strength. Abrams also testified that regulation is a key factor in judging a utility company. Regulation is evaluated by the company's ability to earn a realistic rate of return, the cash quality of earnings, the stability of earning trends, and moderation of the company's need to finance externally. Both the historical and the forecast financial performance of the company are considered here.

Abrams testified that recent Commission actions have raised concerns in the investment community about the company's financial risk. Abrams singled out the 1983 change of the Annual Energy Rate (AER) from 2% to 8%, the prudency review of SONGS 2 and 3 construction costs, the target capacity factor for SONGS 2, the rate base treatment of SONGS 1, and the rate-making treatment of the Sun Desert plant site as examples of increased financial risk to SDG&E.

In Abrams' opinion, a disallowance due to the Agreement will have two significant impacts on SDG&E. First, a disallowance would raise interest expense since the common equity base would be reduced causing the capital structure to be more leveraged. Second, the investment community would regard a disallowance as a major signal of regulatory deterioration in California. This perception would engender the belief that SDG&E faces increased risk on all other matters before the Commission. Abrams further stated that this adverse opinion on California regulation could be applied to all electric and/or gas utilities in California, not just SDG&E.

Abrams concluded that any adverse decision in this proceeding would trigger a special review of SDG&E's credit rating. He warned that if SDG&E's rating is lowered, then SDG&E's financing

costs could increase for some time.

Haney testified that any disallowance based on the Agreement will cast a cloud over the financial standing of SDG&E and every other California utility. In Haney's opinion, the financial community will perceive that the Commission may at any time penalize a utility for earlier actions even when those actions have gone unchallenged for years.

Haney also testified that investors seek out utilities for their stability in earnings. In his opinion, a disallowance in this proceeding could lead to renewed earnings volatility and could even precipitate a reversal of the company's steady financial progress.

Haney testified that any disallowance in this proceeding should be considered with the other significant regulatory issues facing SDG&E. The Commission should be aware that the combination of adverse decisions on the retention of SONGS 1 and the Sun Desert site in rate base and the prudency of SONGS 2 and 3 construction costs could have a harmful impact on the company's financial standing.

Haney suggested that if the Commission desires to minimize the impact on the company's cost of capital, then the earnings cap of 120 basis point adopted in D.83-08-048 could be used in this proceeding. This earnings cap, using the current authorized rate base of $1.7 billion and a 43% common equity ratio, is about $8.8 million.

Abrams also filed some rebuttal testimony in which he tried to quantify the impact of a disallowance on SDG&E after assuming that a refund had been ordered in 1983. If a disallowance of $65 million had been ordered by the Commission, Abrams estimated that the company's interest expense would have increased by $14.4 million to maintain a 3.0 times interest coverage. Abrams then concluded that such a refund to ratepayers would be a short-lived boon and a long-term increase to utility rates because of the

increased interest expense.

2. Staff Evidence

Staff presented one witness on the financial impact of a disallowance on SDG&E, Ray Czahar. Czahar analyzed the impact of an assumed $70 million disallowance. He estimated that the after-tax impact of a $70 million disallowance on SDG&E would be $34.3 million.

Czahar first reviewed SDG&E's key financial indicators for the period 1978-1982. He then forecast SDG&E's cash generation capital requirements and external financing for the period 1984-1988. From this historical and prospective analysis, he determined that SDG&E's financial record has shown steady improvement from 1978-1982 and should continue to improve in future years.

Czahar then analyzed the impact of a $34 million reduction in 1984 common equity earnings on SDG&E. He found that this reduction would not severely alter SDG&E's financial position after 1984. He also found that a $70 million disallowance will not damage SDG&E's credit worthiness so that the utility's ability to deliver safe and reliable service to its customers is threatened.

In rejoinder to Abrams' rebuttal testimony, Czahar testified that if one includes the savings from a lowered common equity base in Abrams' calculation, then the net revenue increase attributable to a $65 million disallowance should amount to $2.2 million not $14.4 million. Czahar stated this would be a one-time revenue increase.

B. Disallowance Calculations

SDG&E presented one witness, Michael Niggli, on disallowance calculations. Staff also presented one witness, Russell Copeland, on this subject.

1. SDG&E Calculations

SDG&E's witness testified that although the company has prepared several calculations, the company believes that no disallowance is appropriate. After presenting each calculation, Niggli added the disclaimer that the calculation should not be used as the basis for a disallowance since the company believes no disallowance is appropriate. The company's efforts throughout this phase of the proceeding were devoted to a refutation of any evidentiary basis for a disallowance.

The first calculation prepared by SDG&E was $97 million. Niggli explained that this figure represented his initial estimate of the actual costs and benefits of the Agreement. In making this calculation, Niggli assumed that the different oil volumes taken under the Agreement could have been replaced by natural gas. Under this assumption, the Agreement could have increased SDG&E's fuel costs by $97 million.

Niggli immediately pointed out that his $97 million calculation was based upon the erroneous assumption that all additional oil volumes under the Agreement could have been replaced with natural gas. Niggli testified that due to supply flow limitations and power plant gas availability, natural gas could not have completely replaced oil in late 1981 and early 1982. If the actual availability of gas is considered, then his $97 million calculation is reduced to $47 million. The present value of the benefits and detriments underlying this figure, valued as of January 1, 1984, is $33 million.

In supplemental testimony, Niggli reduced this $33 million calculation by subtracting prior Commission disallowances of SDG&E fuel costs. Niggli subtracted a fuel disallowance of $6.88 million already ordered in D.82-12-056 and $13 million in unrecovered fuel oil carrying costs. These two adjustments on a present value basis amount to $26.5 million. The $33 million calculation minus these costs is $6.55 million.

Last, Niggli points out that the record already contains data which could be used as a punitive disallowance. In SDG&E's 1979 analysis of the Agreement's costs and benefits, the company had assumed a 50% probability of a $1 barrel penalty for rejected natural gas. Therefore, SDG&E maintains that an acceptable method for calculating a disallowance would be a $.50/barrel penalty for each additional barrel of oil (9.1 million barrels) the company agreed to take under the Agreement. Under this method, the disallowance would amount to $4.55 million. Again, SDG&E emphasizes that although the method exists, it does not believe any disallowance is justified or appropriate.

2. Staff Calculation

Staff witness Russell Copeland recommends a disallowance of $65,008,000.

Copeland first assumed that SDG&E had not signed the Agreement and instead received the low sulfur fuel oil (LSFO) volumes specified in the prior 1974 Tesoro contract, as amended. Copeland further assumed (1) that SDG&E could have burned all available natural gas from 1979-1983, (2) that SDG&E could have disposed of any excess LSFO on the spot market, and (3) that SDG&E could have acquired any needed LSFO above contract volumes on the spot market.

Under the above assumptions, Copeland calculated what SDG&E's total fuel costs would have been for the period 1979-1983 without the Agreement. The natural gas burn and the price of natural gas were derived from SDG&E's operating records and confirmed by data requests to SDG&E's natural gas supplier, the Southern California Gas Company. The amount of natural gas available to SDG&E from 1979-1983 and the price of that gas were taken from these recorded data. The disposal cost of LSFO and the acquisition price of LSFO on the spot market were derived from Lundberg Survey Inc. monthly reports on LSFO prices in Southern California. Here Copeland found that a range of LSFO

prices is shown in the Lundberg reports. If one chose from this range the LSFO prices most favorable to SDG&E (high buying price, low selling price), Copeland found that a disallowance of $26,954,000 could be calculated. However, if one selected the LSFO prices least favorable to SDG&E (low buying price, high selling price), then a disallowance of $114,446,000 could be calculated. The range between these "minimum" and "maximum" calculations is $87.5 million. Realizing that this variation was too large, Copeland refined his analysis. He compared SDG&E's recorded LSFO sales with Lundberg reported prices at the time of each sale. He found that SDG&E had sold its LSFO at a price 70¢ per barrel below the average sales price shown in the Lundberg reports. As a result, Copeland used the Lundberg average price minus 70¢ per barrel as SDG&E's disposal cost. Since Copeland could not find any recorded LSFO purchases by SDG&E to compare with the Lundberg reported prices, he used the Lundberg average price as SDG&E's acquisition price. With these refined disposal costs and acquisition prices for LSFO, Copeland calculated his recommended "mid-range" disallowance of $65,008,000. This figure represents the difference between SDG&E's recorded fuel costs with the Agreement and what SDG&E's fuel costs would have been without the Agreement under Copeland's assumptions.

Copeland also testified that under this method he has subtracted from his recommended disallowance a prior fuel-related penalty of $6.88 million already imposed by the Commission. (See D.82-12-056, pp. 31, 33.)

IV. POSITIONS OF THE PARTIES

A. SDG&E

SDG&E believes that no disallowance or penalty can be jusitified. Although the Commission in its Interim Opinion, D.84-02-005, asked for evidence on the actual consequences of the Agreement, SDG&E argues that the Commission has failed to identify a standard or alternative course of action which the company should have followed against which the actual consequences of the

Agreement can be measured. For this reason, SDG&E submits the actual consequences of the Agreement cannot be determined.

SDG&E contends that the ALJ erred in excluding SDG&E's prepared testimony on the course of action that a reasonable and properly motivated utility would have followed in 1978-1979. Without this type of evidence, SDG&E submits that the Commission cannot fix a disallowance.

SDG&E further contends that the ALJ erred in admitting staff's testimony. SDG&E argues that the staff's calculated disallowance is based on an alternative course of action that realistically was not available to SDG&E. In addition, SDG&E asserts that the staff's disallowance is not limited to the consequences of the Agreement. SDG&E believes that the staff's evidence cannot serve any purpose in calculating the actual consequences of the Agreement and should have been stricken from the record.

Finally, SDG&E submits that any disallowance ordered by the Commission must be proportional to the wrongdoing identified in D.84-02-005. SDG&E states that the only wrongdoing identified in the decision was improper procedures and motivations. SDG&E argues that a penalty for improper procedures and motivations should not exceed the $4.55 million shareholder burden which SDG&E purportedly sought to avoid when it entered into the Agreement.

B. Staff

Staff submits that its proposed $65 million disallowance is the only calculation which covers all actual consequences of the Agreement. Staff further argues that its recommended disallowance should be adopted by the Commission since its financial analysis shows that a disallowance of $70 million will not have any lasting financial impact on SDG&E or on the ratepayers.

Staff contrasts SDG&E's evidence with its own showing on the financial impact of a disallowance.

Staff first describes SDG&E witness Abrams' testimony as nothing more than a general description of the securities rating procedures at Duff and Phelps. Staff then characterizes SDG&E witness Haney's testimony as just a complaint about the Commission's adverse decision on the Agreement.

Staff asserts that its own witness Czahar has presented a well-disciplined analysis consisting of an historical evaluation of SDG&E's key financial indicators from 1978-1982, a forecast of cash generation, capital requirements, and external financing for the period 1984-1992, and a forecast of pre- and after-tax interest coverage from 1984-1988. From this analysis, the staff has concluded that SDG&E's financial outlook is very promising. SDG&E's financial position is so secure that staff believes a disallowance of $70 million will not severely alter SDG&E's financial standing after 1984. If a $70 million disallowance was imposed by the Commision [*sic*] in 1984, staff has found that although the utility's earnings and interest coverage would be lowered in 1984, SDG&E's basic financial position after 1984 would be largely unaffected.

Staff asserts that its affirmative forecast has been substantiated by SDG&E's directors. Staff points out that on May 21, 1984 the directors increased the quarterly common stock dividend 7.1% from 49¢ per share to 52.½¢ per share. Staff notes that SDG&E's directors authorized this dividend increase because they felt the company's financial position had improved despite the uncertainties of a disallowance due to the Agreement and the prudency review of SONGS 2 and 3 construction costs.

Staff submits that the inescapable conclusion to be drawn from the evidence in the record is that a disallowance on the order of $70 million will not materially impair SDG&E's improving financial

prospects nor result in substantial adverse consequences to the ratepayer.

Staff next addresses the various calculations on the actual consequences of the Agreement.

Staff states that despite the Commission's clear directive in D.84-02-005, SDG&E has not presented any meaningful calculations in this phase of the proceeding. Staff claims that SDG&E ignored D.84-02-005 and instead chose to produce testimony by several consultants attacking the Commission's decision. Staff submits that this testimony was properly excluded by the ALJ.

In contrast to SDG&E's showing, staff asserts that its witness Copeland has presented a thorough analysis covering all possible consequences of the Agreement. Staff claims it has meticulously reviewed the company's operations on a day-by-day basis for the period 1979-1983. Staff claims that in this review it has compared SDG&E's actual recorded fuel costs with the Agreement against an extrapolation of the company's fuel costs without the Agreement. The staff chose not to look at the Agreement by itself because the source of LSFO (HIRI, Tesoro, spot market) is not distinguishable after it enters SDG&E's inventory. The staff believes that its method, unlike the company's simplistic calculations, has properly accounted for all consequences that may have flowed from the Agreement.

Staff maintains that the utility has not presented any calculation as an affirmative showing. Instead, SDG&E attempts only to disassociate itself from the $97 million calculation it had previously disclosed to the Commission. Staff notes that the company's witness has disavowed some of his own calculations when he testified that his $97 million figure was based upon incorrect assumptions.

Staff submits that the only well-reasoned calculation of a disallowance has been provided by the staff. The company's

disavowal of its own figures simply underscores the unreliable methodology used by the company. The staff concludes that its disallowance of $65 million should be adopted by the Commission.

C. City

City believes that the staff presented the more credible evidence on the financial impact of a disallowance and on the consequences of the Agreement. Accordingly, City submits that the staff's recommended disallowance should be adopted. Alternatively, City suggests that the Commission may impose a disallowance based upon the economic difference between the Agreement and the underlying 1974 contract with Tesoro, as amended.

City asserts there is a need for a substantial disallowance in this proceeding. City concedes that SDG&E has changed its fuel procurement practices since 1979; however, City contends that a substantial disallowance is necessary to ensure that the company keeps current with the most advanced techniques. City also states that the company's shareholders should bear the economic burden of the Agreement so they will exert pressure on SDG&E's management to continually update the company's fuel procurement procedures.

City divides the financial impact of a disallowance into two categories: (1) the immediate dollar impact on SDG&E's balance sheet and the concurrent effect on the company's ability to provide service, and (2) the effect on the market's perception of the company's financial stability and the concurrent long-term effect on the company's ability to raise capital. City finds that while (1) is easy to measure, (2) is relatively difficult to determine.

City says the immediate impact of a $65-70 million disallowance on SDG&E's balance sheet has been shown in staff witness Czahar's direct testimony and SDG&E witness Abrams' rebuttal testimony. City finds staff's testimony to be more credible for several reasons. First, Czahar analyzed the impact of a disallow-

ance in 1984 and later years through 1992. On the other hand, Abrams evaluated only the impact of a refund ordered in 1983. He conducted no analysis for 1984 or future years. Second, City points out Abrams' calculation of a $14 million revenue increase to cover the increased interest expense was wrong. Cazhar saw that Abrams had failed to include the financial consequences of a reduction in retained earnings. When this factor is considered, Abrams' calculated figure of $14 million drops to $2.2 million. City notes that Czahar's correction of Abrams' calculation was not challenged by SDG&E. Accordingly, City submits that Czahar has proven to be the more accurate and credible witness on this matter. Therefore, the Commission should find that a $70 million disallowance will not affect SDG&E's financial position.

Regarding the market's perception of a disallowance, City emphasizes that two major bond rating houses recently have upgraded SDG&E's rating on bonds, debt, and stock. These agencies raised SDG&E's credit ratings knowing that a disallowance as high as $100 million has been suggested in this proceeding. City also notes that SDG&E's stock has continued to sell above book value during this proceeding. To City, the financial market has demonstrated that SDG&E's financial outlook is sound despite the prospect of a substantial disallowance in this proceeding.

City believes there are two ways to calculate the actual consequences of the Agreement.

First, City asserts that staff witness Copeland's calculated disallowance fairly measures all the consequences of the Agreement. City finds that Copeland has compared the actual events under the Agreement with the course of action SDG&E reasonably could have followed without the Agreement. City asserts that each of Copeland's assumptions is reasonable. In City's view, SDG&E should have burned all natural gas that was available and sold more expensive LSFO on the spot market. City asserts that Copeland's recommended disallowance of $65 million is reasonable and should be adopted.

City describes a second way of calculating a disallowance as the economic difference between the Agreement and the underlying 1974 contract, as amended. In its brief, City has calculated this difference as $74 million based on data drawn from staff and SDG&E exhibits in the record.

City submits that a disallowance of $65 million or $74 million should be adopted by the Commission.

V. ISSUES

The issues raised in this phase of the proceeding are as follows:

1. Should the Commission's fixing of a disallowance be tempered by the financial impact on SDG&E and its ratepayers?
2. Which disallowance calculations best represent the actual consequences of the Agreement?
3. Did the ALJ err in excluding the prepared testimony of SDG&E's hired consultants and in admitting staff's testimony on the consequences of the Agreement?
4. Should the motion of staff and City to compel disclosure of documents be granted?

VI. DISCUSSION

A. Financial Impact

In our Interim Opinion, D.84-02-005, we stated at page 22 that ". . . we will consider the financial impact of a disallowance on SDG&E since the ratepayer ultimately may bear some of that impact." In response to this statement, both staff and SDG&E have presented testimony and evidence on this matter. However, the nature of the two presentations is very different.

SDG&E's direct testimony did not include any specific analysis of SDG&E's financial position or of the impact of a particular disallowance on SDG&E. Instead, this testimony was limited to general predictions of adverse consequences which lacked any reference to SDG&E's financial circumstances. For example, both witnesses proclaimed that a disallowance in this proceeding would lead to a market perception of regulatory decline in California which could adversely affect all California utilities. Clearly, both witnesses sought to avoid any examination of SDG&E's current financial position. One witness, Abrams, initially testified that it would be "impossible" to quantify the impact of a disallowance in advance. However, he later proceeded in his rebuttal testimony to quantify the impact of a $65 million refund made in 1983.

Even the general observations of financial decline offered by SDG&E's witnesses were made without the most rudimentary analysis. For example, one SDG&E witness testified that the Commission's Interim Opinion, D.84-02-005, signaled a change in the standard of review in California. Yet this same witness conceded that he had not read any other Commission decision which addressed the reasonableness and prudency of a utility's actions. An SDG&E witness also testified that the Commission's D.83-08-048 which raised SDG&E's AER from 2% to 8% increased SDG&E's risk of loss *without* any offsetting opportunity for gain. Yet, he made this judgment without conducting any review of the gains or losses experienced by SDG&E under its 2% AER even though he agreed this would be one analytic way of determining whether SDG&E actually faced any increased risk under the revised AER procedures. (It is interesting to note that on August 13, 1984, the Southern California Edison Company filed a Comparative AER Analysis For the Period May 1, 1983 through May 31, 1984 as ordered in D.83-08-048 and reported that its recorded AER revenues exceeded adopted revenues by $50 million. Clearly, the opportunity for utility gains under the Commission's revised AER procedures is substantial.)

SDG&E's predictions of financial gloom and doom have not been substantiated by the investment community. Rather, on April 4, 1984, the Wall Street Journal reported that both Moody's Investors Service, Inc. and Standard & Poor's Corp. raised SDG&E's credit ratings. These two rating agencies increased SDG&E's ratings with the full knowledge that a substantial disallowance could be imposed in this proceeding. SDG&E's Annual Report for 1983 which was released some time in March 1984 states that SDG&E expects the ALJ to recommend a substantial disallowance. And SDG&E representatives had visited both rating agencies several weeks before the upgrade was announced and informed the agencies that possible penalties as high as $100 million have been suggested in this proceeding. Clearly, both agencies determined that despite the prospect of a substantial disallowance in this proceeding, SDG&E's improved financial position warranted higher credit ratings.

The staff's presentation was markedly different from SDG&E's showing. Staff performed a detailed review of SDG&E's past financial performance and prepared an objective forecast of SDG&E's capital requirements in future years. Staff analyzed the impact of an assumed $70 million disallowance and found that a disallowance of this magnitude will not severely alter SDG&E's basic financial position after 1984. During cross-examination, the staff witness further stated that a disallowance up to $120 million will not have an adverse financial impact on SDG&E. In his opinion, SDG&E is in an excellent financial position with or without a disallowance because the construction of SONGS 2 and 3 now is completed and because SDG&E is able to normalize its income taxes.

The staff's presentation on the financial impact of a disallowance was complete and convincing. We are persuaded that SDG&E's financial position is so secure that our fixing of a disallowance up to $70 million should not be constrained by financial impact considerations.

We note that SDG&E submitted rebuttal testimony to the staff presentation after cross-examining the staff witness. In this testimony, SDG&E attempted to show that the adverse impact on the ratepayer of a $65 million disallowance in 1983 could be quantified at some $14.4 million a year in increased interest expense. The staff demonstrated that this figure was substantially overstated since it failed to include the decreased revenues due to lower equity costs. Even using SDG&E's assumption of the required interest coverage, the correct figure, taking into account lower equity costs and higher debt costs, is only $2.2 million. We recall that SDG&E's witness during cross-examination on his direct testimony stated that a disallowance would lower equity revenues and raise debt costs. However, his later submitted rebuttal testimony focused only on the higher debt costs. The failure of this witness to present a complete calculation reflects adversely on his assertions. Our findings on this issue are made with great confidence in the staff presentation. However, even absent the staff showing, we would find SDG&E's presentation to be unreliable and lacking in credibility.

B. Disallowance Calculations

We will address SDG&E's, staff's, and City's disallowance calculations in turn.

1. SDG&E

SDG&E has calculated figures ranging from $97 million to $4.55 million.

The $97 million figure was the first calculation made by SDG&E witness Niggli. This figure is based on the assumption that the lower and higher LSFO volumes stated in the Agreement respectively were replaced by natural gas and displaced available natural gas. However, Niggli subsequently found that the higher LSFO volumes in late 1981 and early 1982 could not have completely displaced natural gas. Therefore, according to Niggli, the $97

million ovestates [*sic*] the detriments attributable to the Agreement in late 1981 and early 1982.

The next figure explained by Niggli is a $33 million calculation. This figure takes into account the limited availability of natural gas in late 1981 and early 1982. In addition, the figure includes LSFO sales losses incurred during this same timeframe which are attributable to the Agreement. This figure purportedly is based upon a comparison of 1974 contract volumes, as amended, with the actual Tesoro deliveries. (However, the final contract volumes shown in Niggli's work papers do not match the recorded Tesoro deliveries shown in the company's data response.) Finally, for this calculation Niggli used present worth factors to value all calculated benefits and detriments of the Agreement on a January 1, 1984 basis.

We find several problems with this second figure. Apart from his inclusion of LSFO sales losses, it is apparent that Niggli has focused only on adjustments which will reduce his $97 million figure. Niggli testified that an exhaustive search and review of SDG&E's operating records revealed that natural gas could not have completely replaced the additional LSFO obligations assumed in the Agreement for late 1981 and 1982. Recognition of this limitation reduced the calculated detriments of the Agreement. On the other hand, Niggli declined to make similar adjustments for the "benefit" period of 1979 to mid-1981 when LSFO contract volumes were lowered.

For example, in January 1979, SDG&E did not burn any natural gas. Nonetheless, Niggli has included a benefit of $1,051,830 for this month based on the erroneous assumption that a lower LSFO volume in this month enabled SDG&E to burn more gas. In January 1981, SDG&E burned 267 MMcf of natural gas equivalent to about 40,000 barrels of LSFO. Yet Niggli has included a benefit in this month of replacing 164,300 barrels of LSFO with natural gas. Thus, he has overstated the actual benefits of the Agreement.

Furthermore, Niggli testified that he did not consider LSFO inventory levels in his calculation. If SDG&E had unused tank capacity, the company would have been able to burn available natural gas whether or not it was obligated to receive higher or lower LSFO volumes under the Agreement. Therefore, if SDG&E had enough tank capacity to store excess LSFO, the Agreement's lower volumes from 1979 to mid-1981 would not have enabled a greater gas burn.

Niggli did not consider such actual operating conditions which would have lowered his calculation of the benefits from the Agreement. Thus, Niggli has not applied a consistent methodology in deriving his $33 million figure. This figure is substantially understated since the calculated benefits have not been adjusted to reflect actual operating conditions in the same manner in which the calculated detriments were adjusted.

In his supplemental testimony, Niggli made two adjustments to his $33 million figure. First, he subtracted a prior disallowance of $6.88 million ordered in D.82-12-056 because the staff in its calculation had deducted this amount. Although Niggli in his rebuttal testimony completely repudiated the staff's methodology, he suggests that his figure should be adjusted in the same way staff's calculation was. Second, Niggli contends that some $13 million in unrecovered LSFO inventory carrying costs should also be recognized and subtracted. As discussed earlier, Niggli did not consider LSFO inventory levels in his method. Yet despite this omission he suggests it is reasonable to subtract the unrecovered carrying costs of excess LSFO to further reduce the $33 million figure. Both of these adjustments to the $33 million figure reveal SDG&E's intent to engage in whatever maneuvers that will lead to a lower disallowance figure. The inconsistent positions taken by SDG&E confirm our belief that SDG&E's evidence should be viewed with skepticism.

The last figure offered by Niggli is $4.55 million. As stated earlier, this figure is based on the shareholder burden that SDG&E

was concerned about when it was evaluating the proposed Agreement. Since we have already found in D.84-02-005 that the Agreement was unreasonable, it would be incongruous to limit the disallowance to an assumption in the underlying company analysis.

First, the 50% probability of a penalty assumed by SDG&E i inapplicable here. SDG&E's estimation of the likelihood of a Commission penalty is not binding on or relevant to the Commission's fixing of a disallowance.

Second, the one-dollar-per-barrel difference between LSFO and gas prices assumed by SDG&E as the potential penalty was just plain wrong.

SDG&E asserts that this difference between the Tesoro price for LSFO and the GN-5 rate for gas is in accord with D.90404, 1 CPUC 2d 596 (June 5, 1979). That decision addressed the reasonableness of certain LSFO sales losses in the record period June 1, 1977 to June 30, 1978. The Commission found that SDG&E had incurred an LSFO sales loss of $5,018,800 but realized some $19.3 million in excess gas revenues. The Commission then decided that SDG&E's electric ratepayers should not bear the burden of the LSFO sales loss and disallowed this amount minus the fuel cost savings from burning gas. (1 CPUC 2d at 629-630.) In effect, SDG&E's electric ratepayers were made indifferent to this transaction. And since at that time a Supply Adjustment Mechanism (SAM) was not in effect, SDG&E, not its gas ratepayers, retained the $19.3 million in excess gas revenues reduced by the disallowed sales loss. SDG&E's gas ratepayers were not affected by the transaction. Thus, the Commission previously was simply addressing the question of whether SDG&E should have retained all the benefits of the LSFO sale without bearing any of the costs.

The Agreement was made in an entirely different set of circumstances. First, a SAM was in effect; therefore, any excess gas revenues flowed through to the gas ratepayers and were not

retained by SDG&E. Second, the Agreement obligated SDG&E to purchase additional LSFO which could displace less expensive gas. The Agreement raised SDG&E's total fuel costs. D.90404 addressed a sale of excess LSFO so that SDG&E could burn more gas. This transaction lowered the company's total fuel costs.

In D.90404, the Commission ensured that the ratepayers were made indifferent to the LSFO sales loss. To reach the same result for the ratepayers in this proceeding, the Commission must consider the actual cost of gas to SDG&E or the G-61 commodity rate. The difference between the G-61 rate and the Tesoro price during the period SDG&E was reviewing the proposed Agreement, January 1979 to May 1979, was:

	$ 7.54/bbl	January 1979
	$ 7.26/bbl	February 1979
	$ 8.02/bbl	March 1979
	$ 8.26/bbl	April 1979
	$ 8.56/bbl	May 1979
Total	$39.64/bbl	
Average	$7.93/bbl	

If the average price difference is inserted in Niggli's suggested method, the shareholder burden which SDG&E's management should have foreseen under the Agreement is 9.125 million barrels × $7.93/bbl = $72,361,000.00. A disallowance of this amount would be proportional to the wrongdoing committed by SDG&E and would be an accurate measure of the risk that should have been foreseen in SDG&E's analysis of the proposed Agreement.

In summary, SDG&E's first calculation of $97 million is based on a consistent method which uses the different contract volume requirements; however, it does not reflect actual operating conditions in the period 1979-1983. SDG&E's subsequent adjustment of this figure to reflect actual operating conditions in late 1981 and early 1982 was not based on a consistent methodology since similar adjustments were not made for the "benefit" period. Furthermore, the work papers for this adjusted figure conflict with

SDG&E's data responses. Finally, SDG&E's last method of calculating a disallowance relies upon the company's earlier analysis of the Agreement. However, this analysis used incorrect assumptions which, if corrected, yield a disallowance figure of $72 million.

2. Staff

Staff recommends a disallowance of $65 million. As discussed earlier, this figure is based on a reconstruction of SDG&E's fuel costs for the period 1979-1983 absent the Agreement.

SDG&E protests that the staff's method goes far beyond the actual consequences of the Agreement. We agree that staff has calculated "credits" and "penalties" on LSFO quantities which exceed the volume changes negotiated in the Agreement. However, this approach does not lead us to SDG&E's conclusion that the calculated disallowance is meaningless. Rather, we conclude that the staff method is a consistent calculation of what SDG&E's fuel costs would have been if SDG&E had burned all available natural gas from 1979-1983.

Staff determined that the primary consequence of the Agreement was the rejection of available natural gas from SDG&E's fuel mix. Staff decided not to confine its analysis to the incremental volume changes of the Agreement because staff was unable to determine the supplier source of LSFO in SDG&E's inventory and in its LSFO burn. Staff, unlike SDG&E, was unwilling to assume that the Agreement's lower LSFO contract volumes necessarily enabled a higher gas burn and that the Agreement's higher contract volumes necessarily resulted in gas rejections. Instead, staff predicated its method on SDG&E's recorded LSFO burn and the recorded availability of natural gas. Reliance on these two factors eliminates the need to determine whether the Agreement's incremental volumes actually replaced or displaced natural gas. Instead, the staff was able to calculate SDG&E's fuel costs based on a maximum gas burn. The staff method implies that the Agreement turned SDG&E's management away from a gas optimization

fuel mix although it would have been reasonable for SDG&E to manage its resources in this manner from 1979-1983.

The critical assumptions underlying the staff figure are the disposal cost of LSFO and the acquisition price of LSFO in the spot market. As one can see from the range of figures calculated by the staff, the use of different LSFO prices can result in a figure as low as $27 million and as high as $114 million. However, we find that staff has selected the best available guidelines in determining from within this range what these disposal costs and purchase prices reasonably would have been.

We do find two flaws in the staff calculation. First, as pointed out by SDG&E, staff has used beginning-of-the-year present value factors rather than mid-year factors. We agree with SDG&E that use of the mid-year factors is appropriate. Second, we note that staff has limited its calculated penalties for gas rejection in the months of July 1980 and January 1981, to the LSFO volumes under the 1974 contract with Tesoro, as amended. The only reason offered by staff for this limitation is that staff did not want to penalize SDG&E for taking any HIRI LSFO. However, there is no valid reason why staff's method should be limited to the underlying 1974 contract volumes. The purpose of staff's method is to maximize the gas burn and to dispose of excess LSFO, regardless of its supplier. The staff's method does not imply that the level of the Tesoro 1974 contract volumes or the HIRI LSFO volumes were unreasonable but only that SDG&E should have disposed of this LSFO if it could be replaced with gas. If one corrects these two flaws, staff's calculation is reduced to $63,647,000.

3. City

The City's alternative calculation of $74 million is based on a hybrid approach. City has used SDG&E's exhibits and data responses to calculate what the benefits of the Agreement were from 1979 to mid-1981. City then draws upon the staff exhibit to determine what the detriments of the Agreement were from

mid-1981 to 1983.

The City's approach is subject to the same criticisms we have made of SDG&E and staff calculation methods.

The City's determination of benefits from the Agreement is overstated to the extent it does not recognize the actual gas burn or take into account LSFO storage availability. The City has assumed like SDG&E that the Agreement's lower LSFO volumes from 1979 to mid-1981 enabled SDG&E to burn more gas. This has not been demonstrated on this record.

The City's determination of detriments from the Agreement does recognize SDG&E's actual operating conditions since it is taken from the staff calculation. However, the City also has used improper present value factors and limitations on gas rejections.

City has not explained why this hybrid approach is appropriate other than to say that in its view this is one way to measure the economic difference between the Agreement and the underlying 1974 contract with Tesoro, as amended.

4. The ALJ's Recommended Disallowance

The record now contains three disallowance figures which may be adopted by the Commission: $97 million, $72 million, and $63 million.

The $97 million figure increases slightly to $98 million if present value factors are used. Again, this figure is based on replacement fuel costs for the different LSFO volume requirements imposed by the Agreement. It is not based upon actual LSFO deliveries or the recorded availability of natural gas but refers only to the actual contract changes with Tesoro.

The second $72 million figure is drawn from SDG&E's proposal to disallow the risk or burden assumed by SDG&E in its analysis of

the proposed Agreement. Under this method, SDG&E is penalized for the risk that it reasonably should have foreseen when it signed the Agreement.

The third $63 million figure is derived under the staff method from recorded data. This method assumes that absent the Agreement SDG&E could have managed its fuel mix to take advantage of all available natural gas. This method does incorporate SDG&E's recorded LSFO burn and the recorded availability of natural gas.

In addition to these three figures, the Commission may develop its own disallowance figure drawn from the considerable evidence received in the record for this proceeding. For example, we can see from SDG&E's data responses that in 1979 SDG&E had adequate storage capacity to accept the unreduced Tesoro LSFO volumes and still burn all available natural gas. Thus, the Commission may conclude that the Agreement actually resulted in no benefits in 1979 other than a lower LSFO inventory level. And of course since SDG&E's shareholders bore excess inventory carrying costs in 1979, the ratepayers would not have received any benefit of a reduced LSFO inventory in that year. As another example, the Commission could calculate what the benefits of the Agreement were by examining actual Tesoro deliveries from 1979 to mid-1981 rather than the final contract levels. Most of these refinements would raise a disallowance figure calculated by the parties.

The ALJ proposed that the Commission adopt a disallowance of $70 million to be refunded to SDG&E's ratepayers in its ECAC balancing account. In the ALJ's view, this recommended disallowance is towards the low end of the three disallowance figures that could be adopted. According to the ALJ, since some of these figures could be increased, it is a minimal figure, when viewed in the light of Czahar's financial analysis which indicates that a $70 million disallowance will not have a lasting financial impact on SDG&E, and that a disallowance as high as $120 million will not harm SDG&E.

5. The Adopted Disallowance

In our Interim Opinion, D.84-02-005, we directed the parties to submit calculations on the actual consequences of the Agreement. Although we found that the Agreement was unreasonable, at that time we did not know what the effects of the Agreement were apart from the $45 million in underlift payments made under the 1982 Tesoro Suspension Agreement. At that point we could have simply disallowed the $45 million in underlift payments. However, since SDG&E claimed it had entered into the Agreement to enable a greater gas burn in 1979 and 1980, we extended the proceeding to determine what fuel savings had occurred due to the lower contract volumes in those years. It was our expectation that consideration of the fuel savings would offset some of the underlift payments. This was not the case.

After reviewing SDG&E's records, we now know that the Agreement's lower volumes for 1979 did not enable a greater gas burn or any fuel savings. SDG&E could have accepted the original Tesoro volumes and still burned all available gas in 1979. Any excess LSFO could have been stored in SDG&E's inventory. (SDG&E's average LSFO inventory level in 1979 was 1.873 million barrels while its tank capacity was 3.8 million barrels.) By entering into the Agreement, SDG&E was able to reduce its LSFO inventory carrying cost in 1979. The Agreement's lower volume in that year did not affect the gas burn. However, in 1980 and the first half of 1981, SDG&E did realize some fuel savings due to the Agreement's lower volumes. Most of the savings occurred in the first half of 1981 because the oil/gas price differential unexpectedly had increased to $24-$30 per barrel.

After mid-1981, the Agreement's extended term raised SDG&E's fuel costs. The Agreement's higher volumes in the mid-1981 to 1983 period forced SDG&E to reject cheaper natural gas, to sell excess LSFO at a loss, and to pay underlift penalties to Tesoro. In addition, the Agreement increased SDG&E's inventory carrying costs over this period. From mid-1981, the Agreement

increased SDG&E's fuel expenses.

There are several ways of quantifying the above consequences of the Agreement. The ALJ proposed a disallowance of $70 million. This recommendation is drawn from a range of $63 million to $97 million which he finds is established in the record. We agree that the Agreement has increased SDG&E's fuel costs over the 1979-1983 period by at least $60 million,[1] and perhaps as high as $97 million. We are simply not comfortable with this range of figures.

We will confine our consideration of the disallowance to expenses caused by the agreement with Tesoro in the period July 1, 1982 to December 31, 1983. Although this record period concludes April 30, 1983, we have necessarily reviewed all of the costs related to SDG&E's Tesoro agreements in this proceeding. We choose not to adjust the balancing account for the period January 1, 1979 to June 30, 1982.

We are reluctant to make adjustments to the expenses incurred in record periods for which we already have issued decisions. We already have reviewed the January 1, 1980 to June 30, 1982 period and issued decisions on the reasonableness of expenses incurred over that time period. (See D.82-04-115 issued April 28, 1982 and D.82-12-056 issued December 13, 1982). While we have only partially reviewed the 1979 record period and have retained jurisdiction to disallow fuel related expenses for that prior period,[2] the Agreement itself did not affect fuel expenses in that year, and the exclusion of this period does not change the disallowance.

We also note that inclusion of this period would raise the calculated disallowance since the Agreement did not bring about any

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[1] Even SDG&E's calculation of $33 million increases to $60.5 million when the 1979 fuel savings is removed.

[2] See the "express reservation" provisions of D.91106 issued December 19, 1979 and D.91545 issued April 15, 1980.

fuel savings in 1979. The realized fuel savings in 1980 and the first half of 1981 are substantially outweighed by the later expense from rejecting natural gas, the losses on excess LSFO sales, and the underlift payments to Tesoro in the July 1, 1981 to June 30, 1982 period. Consideration of the January 1, 1979 to June 30, 1982 period increases rather than decreases the disallowance which could be imposed on SDG&E.

We recall the Commission's statement in D.92496 issued December 5, 1980 that adjustments to prior record periods "could be damaging to the financial standing of California utilities because of the corresponding assumption that reported earnings would be subject to possible adjustment for years in the future." (4 CPUC 2d 701.) By confining our consideration of the disallowance to the July 1, 1982 - December 31, 1983 period, we will avoid adjustment of prior reported earnings for SDG&E.

In reviewing the full range of figures developed in this record, we conclude that the only solid figure is the underlift penalty associated with the Suspension Agreement. In making a disallowance, we will not attempt a calculation for the record period months of July, August and September 1982, because we are not comfortable calculating a figure for the oil/gas differential for these months. However we know that from October 1, 1982 to December 31, 1983, SDG&E did not receive any LSFO from Tesoro and instead paid a $6.55/bbl underlift penalty, or a total of $45,060,000 in underlift penalties. This is the amount we will disallow.

We emphasize that we will continue to review discretionary utility actions and management decisions which affect expenses in a record period even though those actions and decisions may have been made at an earlier time. For example, the reasonableness of expenses paid pursuant to a particular long-term contract will be an issue not only initially as to whether the utility should have entered the contract at all, but further in each and every record period for which rate recovery is sought, and for which the

contract is in effect. Otherwise, a utility could be encouraged to enter into contracts which may yield immediate benefits but over the contract term are imprudent. Recently, we addressed this very issue in reviewing the increased coal costs resulting from the renegotiation of Edison's contract with Utah International Corp., in Edison's 1982 reasonableness review proceeding. In our decision we concluded that "The price paid under the renegotiated Utah International coal supply contract was reasonable during the review period; Edison for future reasonableness periods should bear the burden of proving the reasonableness of the price paid under the renegotiated terms." (D.84-09-120, mimeo. p. 98.)

To reiterate, our primary focus is the review of the reasonableness of expenses incurred by a utility during the record period, *given the existence of the contract*. To accomplish this task, it may be necessary to continuously reassess the reasonableness of the contract itself. This does not mean that long-term contracts are to be discouraged in favor of "flexible" short-term contracts or that the intrinsic benefits often embodied in long-term contracts will be disregarded for ratemaking purposes. We merely state the obvious: neither utility management nor utility regulators operate in a static environment. Both must act responsibly and responsively as circumstances change. As a previous Commission so aptly stated:

> "[The utility's] theory that once it is determined that it entered into a reasonable and prudent contract, its shareholders are absolved from all risks, is not correct in that it neglects the very important factor of changed cirumstances [*sic*].
>
> "Whether or not a contract should remain in effect, be abrogated, or be renegotiated should be decided by utility management. It seems obvious that normally utility management will consider a change in the status quo only when there is an incentive for it to do so. If we pass through all expenses without determining their reasonableness simply because they have been contracted for, there would never

> be an incentive for utility review of such expenses. Our review of the reasonableness of contract expenses with the possibility of disallowance provides management incentive to incur only reasonable costs." (D.82-12-109 10 CPUC 2d 488, 492-493.)

We fully expect this disallowance will be the last of its type for SDG&E. SDG&E does have new procedures and new personnel in its fuel procurement department. We are confident that with these changes, current management has taken the steps necessary to avoid the kind of mistakes of the past that led to the Agreement causing this disallowance.

C. ALJ Rulings

SDG&E asks the Commission to overturn the ALJ's evidentiary rulings excluding some of SDG&E's prepared testimony and admitting staff testimony.

A review of the excluded testimony shows that it was prepared to reargue the reasonableness of the Agreement. SDG&E has read the Interim Opinion, D.84-02-005 to say only that SDG&E's procedures and motivations were unreasonable, not the Agreement. SDG&E's hired consultants then were instructed to determine whether absent these unreasonable procedures and motivations, SDG&E reasonably could have entered into the Agreement. Not surprisingly, each of the consultants has concluded that the Agreement was "reasonable."

D.84-02-005 clearly states that the Agreement was unreasonable based upon the facts known to SDG&E at the time it entered into the Agreement. After the Commission found that the Agreement itself was unreasonable, the Commission went on in D.84-02-005 to discuss some of the reasons why SDG&E entered into such an unreasonable Agreement. The Commission stated that SDG&E had not conducted adequate studies, SDG&E had not properly evaluated the uncertainty of its gas forecasts, and SDG&E had

attempted to shield its shareholders from certain penalties at the expense of the ratepayers. The primary finding that the Agreement was unreasonable is not dependent on the latter discussion which identifies additional conduct by SDG&E that was unreasonable.

In short, SDG&E does not accept the plain meaning of D.84-02-005 and has sought in its excluded testimony to relitigate the reasonableness of the Agreement. The ALJ has properly excluded this evidence.

We observe that D.84-02-005 was issued after the receipt of testimony from the SDG&E officer who actually signed the Agreement in 1979. Such testimony is the best evidence that could be offered of the circumstances surrounding the Agreement. The testimony of hired consultants who did not participate in the negotiation or the signing of the Agreement would pale in comparison to the testimony of such a percipient witness.

SDG&E also argues that since the Interim Opinion did not describe an alternative course of action, the Commission has not yet determined that the Agreement was unreasonable, just SDG&E's procedures and motivations. There are *many* reasonable courses of action that SDG&E could have followed in 1979. The Agreement was not one of them. If this truly is not apparent to SDG&E , [*sic*] we must conclude that despite its loud claims of improvement, SDG&E's fuel management department has not progressed since 1979.

A reasonable and prudent utility manager would not have signed the Agreement that SDG&E did. As stated in D.84-02-055, SDG&E extended its Tesoro obligation beyond the expiration date to a period when it already had under contract adequate LSFO supplies from HIRI. SDG&E signed the Agreement when its probability analysis indicated that the different LSFO volumes created just offsetting risks of excess LSFO. SDG&E signed the Agreement when its own economic analysis predicted net fuel savings of

just $500,000. And SDG&E signed the Agreement, whose primary benefit supposedly was a reduction of contract volumes in 1979 and 1980 to enable an increased gas burn, when the most recent projection of LSFO requirements cited by its witness showed that LSFO requirements exceeded the total supplier volumes *without* any reduction in contract volumes.

A reasonable and prudent utility manager would have undertaken a course of action in which the perceived benefits outweighed the risks. SDG&E did just the opposite.

A reasonable and prudent utility manager would have recognized in 1979 that since its forecasts were highly uncertain, the company should certainly maintain and strive to increase its fuel mix flexibility to allow for unexpected conditions. As stated in D.84-02-005, SDG&E unwisely gave up the flexibility it had under the HIRI contract when it signed the Agreement. SDG&E to this day does not acknowledge that it had any flexibility under the HIRI contract. Of course, SDG&E realizes now that reliance on the flexibility of the HIRI contract was one obvious alternative to the Agreement which would have substantially lowered its fuel costs.

SDG&E's narrow interpretation of the HIRI contract provisions is not supported by the facts. As can be seen in the following table, from 1974 to 1978 SDG&E was able to negotiate large reductions of the original contract volumes without paying any underlift charges to HIRI.

Table 1

HIRI Contract Requirements - MBBL Per Year

	1975	**1976**	**1977**	**1978**	**1979**	**1980**
8/74 Contract	6,278	7,665	10,512	10,512	10,512	10,512
11/74 Amend. 1	5,427	7;665	10,512	10,512	10,512	10,512
2/76 Amend. 2		6,768	10,512	10,512	10,512	10,512
8/76 Amend. 4			6,935	10,512	10,512	10,512
11/77 Amend. 6				6,132	10,512	10,512
5/78 Amend. 7				5,366	5,110	5,110

By 1979, SDG&E on five occasions was able to negotiate substantial volume reductions when it became apparent that it did not need as much LSFO as the contract required SDG&E to take.

Amendment No. 7 was in effect when SDG&E signed the Agreement. SDG&E's witness Niggli testified that in his opinion Amendment No. 7 increased the flexibility in volumes SDG&E already had under the HIRI contract. This opinion is confirmed by the fact that SDG&E was able to subsequently negotiate another large reduction in the minimum contract volumes without paying any underlift charges to HIRI.

As suggested in D.84-02-005, a prudent and reasonable utility manager would have relied upon the flexibility in the HIRI contract. SDG&E literally threw this flexibility away. The company should have known that it would have been better off not signing the Agreement. We do not say now or in D.84-02-005 that the only path SDG&E reasonably could have followed in 1979 was adherence to the status quo. In D.84-02-005, we simply have found that the Agreement was an unreasonable alternative to the status quo. Based on the facts and circumstances existent in 1979, the Agreement was a step in the wrong direction. There are perhaps more reasonable courses of action the company could have followed rather than adhering to the status quo. However, SDG&E has not attempted to present these alternatives in its testimony and instead has tried only to reargue the reasonableness of the Agreement.[3]

On the other hand, staff has presented in its testimony an alternative to the Agreement which in staff's opinion was a reasonable course of action available to SDG&E in 1979. Staff has fully accepted the finding in D.84-02-005 that the Agreement was

[3] Although one SDG&E witness, William Hughes, does identify several alternatives to the Agreement, his prepared testimony is not a measurement of the likely consequences of these alternatives against the recorded costs under the Agreement. Rather, his testimony is limited to a determination that in late 1978 none of his selected alternatives seemed better than the Agreement.

unreasonable; SDG&E clearly has not. For this reason, staff's evidence was properly admitted while SDG&E's evidence was excluded.

SDG&E's motion to overturn the ALJ's evidentiary rulings shall be denied.

E. Disclosure of Documents

SDG&E admits that it has given less than six documents to Commissioners or their aides which were not served upon the parties. SDG&E was unwilling to reveal the contents of these documents and stated only that they were distributed before the Commission issued D.84-02-005.

SDG&E has not denied the relevance of these documents to this phase of the proceeding. Accordingly, we must assume that they are relevant to the determination of a disallowance in this phase of the proceeding.

Public Utilities Code (PUC) § 1705 requires this Commission to make findings of fact and conclusions of law based on evidence in the record. The parties are entitled to examine these documents so that they may assure themselves that the Commission has properly based its ultimate decision on the record. We will direct SDG&E to serve the documents on all parties.

Findings of Fact

1. A disallowance of $70 million will not severely alter SDG&E's financial position after 1984.

2. SDG&E's financial position is substantially improved since the construction of SONGS 2 and 3 is completed and the company is able to normalize its income taxes.

3. A disallowance of $70 million will not harm SDG&E's credit worthiness or threaten its ability to provide safe and reliable

service to its customers.

4. SDG&E's evidence and testimony on the financial impact of a disallowance was not supported by any analysis of SDG&E's current financial condition and lacked credibility.

5. A disallowance figure of $97 million may be calculated based on the LSFO volume differences negotiated in the Agreement and subsequent contract amendments.

6. A disallowance figure of $72 million may be calculated based on the risk that was reasonably foreseeable to SDG&E when it signed the Agreement.

7. A disallowance figure of $63 million may be calculated based on a maximum burn of natural gas that was available to SDG&E from 1979-1983.

8. Some of the disallowance figures could be increased if SDG&E's actual operating conditions from 1979 to mid-1983 are recognized.

9. SDG&E's adjustments to the $97 million figure were limited to the detriment period of mid-1981 to 1983; SDG&E did not make similar adjustments for the benefit period of 1979 to mid-1981.

10. The ALJ proposes a disallowance of $70 million based on the range of disallowance figures in the record and the staff's financial analysis.

11. SDG&E in the testimony of its hired consultants attempted to reargue the reasonableness of the Agreement.

12. SDG&E has misread D.84-02-005 to say only that the company's procedures and motivations were improper.

13. D.84-02-005 clearly states that the Agreement was unreasonable based upon the facts known to SDG&E at the time it signed the Agreement.

14. SDG&E has informally distributed documents to Commissioners or their aides which were not served on all parties to this proceeding.

15. The assigned Commissioner issued a ruling denying SDG&E's petition to disqualify the ALJ in this proceeding.

16. To eliminate any uncertainty over the outcome of this proceeding, this order should take effect on the date of issuance.

17. A disallowance of $45,060,000.00 is appropriate based on the underlift payments ($6.65/Bbl) made by SDG&E to Tesoro from October 1, 1982 to December 31, 1983.

18. Disallowance of expenses incurred in prior record periods should be avoided so that a utility's reported earnings for those periods are not affected.

Conclusions of Law

1. The disallowance adopted in this decision is just and reasonable.

2. The ALJ's evidentiary rulings were correct.

3. SDG&E should serve upon the parties the documents that it has informally given to Commissioners or their aides.

4. The assigned Commissioner's ruling declining to disqualify ALJ Wu should be affirmed.

FINAL ORDER

IT IS ORDERED that:

1. San Diego Gas & Electric Company (SDG&E) shall refund to its ratepayers $45,060,000.00 as of January 1, 1985 through its Energy Cost Adjustment Clause balancing account.

2. SDG&E's motion to overturn the Administrative Law Judge's evidentiary rulings is denied.

3. SDG&E shall, within 10 days of the date of issuance of this order, serve upon all parties all documents it has distributed to Commissioners or their aides.

4. The assigned Commissioner's ruling is affirmed.

This order is effective today.

Dated December 5, 1984, at San Francisco, California.

DONALD VIAL
President
VICTOR CALVO
PRISCILLA C. GREW
Commissioners

I dissent.

/s/ WILLIAM T. BAGLEY
Commissioner

I dissent.

/s/ FREDERICK R. DUDA
Commissioner

Decision 85 04 111 APR 17 1985

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SAN DIEGO GAS AND ELECTRIC COMPANY, for authority to revise its Energy Cost Adjustment Clause Rate, to revise its Annual Energy Rate, and to revise its Electric Base Rates in accordance with the Electrical Revenue Adjustment Mechanism established by Decision 93892.	Application 83-07-16 (Filed July 8, 1983)

ORDER MODIFYING DECISION 84-12-026 AND DENYING REHEARING OF DECISIONS 84-02-005 AND 84-12-026

Applications for rehearing of Decisions (D.) 84-02-005 and 84-12-026 have been filed by the San Diego Gas & Electric Company (SDG&E). Those decisions were issued on February 1 and December 5, 1984, respectively. At SDG&E's request, action on its timely filed application for rehearing of D.84-02-005 was deferred until such time as both of its applications could be reviewed. We have examined all allegations of legal error raised by both applications and are of the opinion that sufficient grounds for granting rehearing have not been shown. However, our further review of the entire record in this case has persuaded us that several areas of the disallowance decision, D.84-12-026, should be modified, as set forth below.

IT IS ORDERED that D.84-12-026 is modified as follows:

1. The last paragraph of the discussion on page 29, mimeo, which continues to page 30, is modified to read:

> "There are several ways of quantifying the above consequences of the Agreement. The ALJ proposed a disallowance of $70 million. This recommendation is drawn from a range of $63 million to $97 million which he finds is established in the record. We agree that the Agreement had increased SDG&E's fuel costs over the 1979-1983 period by at least $60 million, and perhaps as high as $97 million. However, as stated in D.84-02-005, we may determine an appropriate disallowance both from these calculations and all other relevant factors, and are not bound by the arithmetic results."

2. The first two full paragraphs on page 30, mimeo., are modified to read:

> "We will confine our consideration of the disallowance to expenses caused by the agreement with Tesoro in the period July 1, 1982 to December 31, 1983. Although this record period concludes April 30, 1983, we have necessarily reviewed all of the costs related to SDG&E's Tesoro agreements in this proceeding. While we could have reached back to the beginning of the Agreement, for reasons largely unique to this case we will not adjust the balancing account for the period January 1, 1979 to June 30, 1982.
>
> "We are reluctant to make adjustments to the expenses incurred in record periods for which we already have issued reasonableness decisions. [The remainder of the paragraph is the same.]"

3. The first paragraph on page 31, mimeo., is modified to read:

> "We recall the Commission's statement in D.92496 issued December 5, 1980 that adjustments to prior record periods "could be damaging to the financial standing of California utilities because of the corresponding assumption that reported earnings would be subject to possible adjustment for years in the future." (4 CPUC 2d 701). By confining our consideration of the disallowance to the July 1, 1982-December 31, 1983 period, we will avoid adjustment of prior reported earnings for SDG&E. We stress, however, that it is not only this consideration, but also the unique factors, discussed above, which this case presents, which have compelled our approach here."

4. The second paragraph on page 31, mimeo., is deleted and the following paragraph substituted:

> "From July 1, 1982 to December 31, 1983, SDG&E incurred the following expenses due to the Agreement. In the months of July, August, and September 1982, SDG&E rejected 952,500 barrels equivalent of natural gas. The oil/gas price differential at this time was about $15. However, we will use the $7.93/bbl average difference calculated by the ALJ for the period January-May 1979. We believe that any disallowance should be limited to the price differential that was reasonably foreseeable when SDG&E entered into the Agreement. Accordingly, an appropriate disallowance for these three months would be 952,000 barrels × $7.93/bbl = $7,553,325.00. From October 1, 1982 to December 31, 1983, SDG&E did not receive any LSFO from Tesoro but instead paid $6.55/bbl

underlift penalty or a total of $45,060,000.00 in underlift penalties. This amount should also be added to the disallowance for this period as a cost which was not reasonably incurred. The total disallowance for the entire period would be $52,613,325.00. We could assess this disallowance against SDG&E with impunity, as it is fully supported by the record. However, our sense of equity persuades us that this amount is somewhat too great a burden for SDG&E to bear. We will, therefore, adopt as the appropriate disallowance only the $45,060,000 in underlift penalties. This amount shall be refunded, to SDG&E's ratepayers through the balancing account effective January 1, 1984."

5. The first full paragraph on page 34, mimeo., is modified to read:

"SDG&E also argues that since the Interim Opinion did not describe an alternative course of action, the Commission has not yet determined that the Agreement was unreasonable, just SDG&E's procedures and motivations. There are *many* reasonable courses of action that SDG&E could have followed in 1979. The Agreement was not one of them."

6. The last paragraph on page 34, continuing on page 35, mimeo., is modified to read:

"A reasonable and prudent utility manager would have recognized in 1979 that since its forecasts were highly uncertain, the company should certainly maintain and strive to increase its fuel mix flexibility to allow for unexpected conditions. As stated in D.84-02-005, SDG&E unwisely gave up the flexibility it had under the HIRI contract when it signed

the Agreement. SDG&E to this day does not acknowledge that it had any flexibility under the HIRI contract."

7. Finding 17 is modified to read:

"A disallowance of $52.6 million is fully supported by the record and would be appropriate in this cse if (1) the disallowance is limited to expenses incurred in the July 1, 1982 to December 31, 1983 period and (2) the disallowance is further limited to the risk that SDG&E reasonably should have foreseen when it signed the Agreement."

8. New Finding 17A is added to read:

"A disallowance of $45,060,000, corresponding to the underlift penalties SDG&E had to pay after it ceased taking LSFO from Tesoro, comports with our sense of equity in this case."

9. Finding 18 is modified to read:

"Disallowance of expenses incurred in prior record periods, which would affect a utility's reported earnings for those periods, should be avoided in this case because reasonableness reviews have already occurred for some of those periods, inclusion of the 1979 period would not change the result because fuel costs were unaffected, and inclusion of the remaining periods would necessitate raising the amount of the disallowance."

10. Ordering Paragraph 1 is modified to read:

"San Diego Gas & Electric Company (SDG&E) shall refund to its ratepayers $45,060,000.00 million, as

of January 1, 1985 through its Energy Cost Adjustment Clause balancing account."

IT IS FURTHER ORDERED that rehearing of D.84-02-005 is denied.

IT IS FURTHER ORDERED that rehearing of D.84-12-026 as modified above is denied.

This order is effective today.

Dated April 17 1985, at San Francisco, California.

DONALD VIAL
President
VICTOR CALVO
WILLIAM T. EAGLEY
FREDERICK R. DUDA
Commissioners

I dissent.

PRISCILLA C. GREW, Commissioner

A.83-07-16
D.85-04-111

PRISCILLA C. GREW, Commissioner, Dissenting in part:

While I agree with the majority that the application for rehearing should be denied, I would order the company to refund to its ratepayers $52.6 million, with interest, as of January 1, 1984, through its Energy Cost Adjustment Clause balancing account.

I support the majority's disallowance of $45 million in underlift penalties. However, I would also add the additional expense incurred in July, August and September 1982 when SDG&E rejected 952,000 barrels equivalent of cheaper natural gas. While an even larger disallowance could be justified using the oil to gas price differential existing at that time, I would accept the ALJ's value of a differential of $7.93/bbl leading to a disallowance of $7,553,325. I would add this amount to the $45 million, giving $52.6 million.

In a recent filing objecting to SDG&E's application for rehearing, the City of San Diego included a request for interest on the disallowance. The Commission's usual practice in similar situations has been to include interest, and there is no obvious reason why it should not be included here.

/s/ Priscilla C. Grew
PRISCILLA C. GREW, Commissioner

April 26, 1985
San Francisco, California

A-74

ORDER DENYING WRIT OF REVIEW

S.F. No. 24889

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA

IN BANK

SUPREME COURT
FILED
SEP 24 1985
Lawrence P. Gill, Clerk
DEPUTY

SAN DIEGO GAS AND ELECTRIC COMPANY, Petitioner

v.

PUBLIC UTILITIES COMMISSION ET AL., Respondents

Petition for writ of review DENIED.

Bird
Chief Justice

IN THE SUPREME COURT OF THE
STATE OF CALIFORNIA

San Diego Gas & Electric Company Appellant v. The Public Utilities Commission of the State of California, Appellee.	No. 24889 RECEIVED 85 DEC 2 SUPREME COURT SAN FRANCISCO

NOTICE OF APPEAL TO THE SUPREME COURT
OF THE UNITED STATES

Notice is hereby given that San Diego Gas & Electric Company, the appellant above-named, hereby appeals to the Supreme Court of the United States from the final judgement of the Supreme Court of the State of California, denying a writ of review of the decisions of the Public Utilities Commission of the State of California, entered in this action on September 24, 1985.

This appeal is taken pursuant to 28 U.S.C. § 1257(2).

Date: November 27, 1985

Jeffrey L. Guttero
Barton M. Myerson
101 Ash Street
San Diego, California 92101
(619) 235-7818

BY: Barton M. Myerson
Barton M. Myerson
Attorneys for Appellant
San Diego Gas & Electric Company

PROOF OF SERVICE BY MAIL

I, the undersigned state that I am a citizen of the United States and employed in the City and County of San Diego; that I am over the age of eighteen (18) years and not a party to the within cause; that my business address is 101 Ash Street, San Diego, California 92101; and that on the date set out below I deposited a true copy of the attached

NOTICE OF APPEAL TO THE SUPREME COURT OF THE UNITED STATES

sealed in envelopes with postage thereon fully prepaid in a mailbox regularly maintained by the Government of the United States in the said City and County and addressed as follows

City of San Diego
Leslie J. Girard
Deputy City Attorney
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San Diego, CA 92101

Janice E. Kerr
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247 University Hall
Berkeley, CA 94720

I certify under penalty of perjury under the laws of the State of California that the foregoing is true and correct:

November 27, 1985
(Date)

Adrienne Lapinan
(Signature)

LIST OF PROCEEDINGS INVOLVING PRUDENCE REVIEWS PENDING BEFORE THE CALIFORNIA PUBLIC UTILITIES COMMISSION

1. Application 82-02-40, *et al.*

   San Diego Gas & Electric Company (SDG&E) and Southern California Edison Company (Edison) have invested approximately *$4.5 billion* in San Onofre Nuclear Generating Station Units 2 and 3. The Commission expects to issue a decision in late 1986 after considering its Staffs' allegations that almost $1.2 billion of project costs were imprudently incurred.

2. Application 84-06-014.

   Pacific Gas and Electric Company (PGandE) has invested over $5.4 billion in its Diablo Canyon Nuclear Plant. The Commission will scrutinize the prudence of PGandE's investment during 1986.

3. Application 85-05-114.

   Edison owns 15.8 percent of the Palo Verde Nuclear Generating Station nuclear project. The Commission will review Edison's approximate $1.5 billion investment in this plant in 1986.

4. Application 85-05-055.

   Edison paid Chevron Oil Company approximately $350 million to settle a lawsuit concerning Edison's termination of a long-term fuel supply contract. The prudence of Edison's actions will be considered by the Commission during 1985-1986.

tion, the Supreme Court has recently upheld legislation prohibiting the dissemination of material depicting children engaged in sexual conduct. *New York v. Ferber*, 458 U.S. 747, 102 S.Ct. 3348, 73 L.Ed.2d 1113 (1982).

Having found that the Ordinance at issue here seeks to regulate speech (and not conduct), the next question before the Court is whether the Ordinance, which seeks to restrict the distribution, sale, and exhibition of "pornography" as a form of sex discrimination against women, falls within one of the established categories of speech subject to permissible government regulation, that is, speech deemed to be unprotected by the First Amendment.

It is clear that this case does not present issues relating to profanity, libel, or "fighting words."[1] In searching for an analytical "peg," the plaintiffs argue that the Ordinance most closely resembles obscenity, and is, therefore, subject to the requirements set forth in *Miller v. California*, 413 U.S. 15, 93 S.Ct. 2607, 37 L.Ed.2d 419 (1973). (Plaintiffs' Memorandum Of Law In Support Of Moving Plaintiffs' Motion Pursuant to Federal Rules of Civil Procedure 56 for Summary Judgment, pp. 18-23). But the defendants admit that the scope of the Ordinance is not limited to the regulation of legally obscene material as defined in *Miller*. (*See*, Answer of Defendants William H. Hudnut, III, et al., ¶ 9). In fact, defendants concede that the "pornography" they

[1] Defendants attempt to utilize the language "[words] by their very utterance inflict injury or tend to incite an immediate breach of the peace," *Chaplinsky*, 315 U.S. at 572, 62 S.Ct. at 769, as legal justification for upholding the Ordinance as unprotected speech. Their argument is that pornography "is nothing more than the infliction of injury on women," and is, therefore, unprotected under the First Amendment. (Defendants' Memorandum In Opposition To Plaintiffs' Motion For Summary Judgment, p.22.) In coming to this view, however, defendants have read this passage out of context. The quoted portion of *Chaplinsky* is in reference to the category of speech known as "fighting words," which by their very nature carry the immediate potential for injury. But "pornography" does not fall within the meaning of "fighting words," as that concept has come to be used. The rationale of *Chaplinsky* is, therefore, distinguishable from the instant case and thus not applicable here.

seek to control goes beyond obscenity, as defined by the Supreme Court and excepted from First Amendment protections. Accordingly, the parties agree that the materials encompassed in the restrictions set out in the Ordinance include to some extent what have traditionally been protected materials.

The test under *Miller* for determining whether material is legal obscenity is:

> "(a) whether 'the average person, applying contemporary community standards' would find that the work, taken as a whole, appeals to the purient [sic] interest, ...; (b) whether the work depicts or describes, in a patently offensive way, sexual conduct specifically defined by the applicable state law; and (c) whether the work, taken as a whole, lacks serious literary, artistic, political, or scientific value." (citations omitted)

413 U.S. at 24, 93 S.Ct. at 2615.

It is obvious that this three-step test is not directly applicable [to] the present case, because, as has been noted, the Ordinance goes beyond legally obscene material in imposing its controls. The restrictions in the Indianapolis ordinance reach what has otherwise traditionally been regarded as protected speech under the *Miller* test. Beyond that, the Ordinance does not speak in terms of a "community standard" or attempt to restrict the dissemination of material that appeals to the "prurient interest." Nor has the Ordinance been drafted in a way to limit only distributions of "patently offensive" materials. Neither does it provide for the dissemination of works which, though "pornographic," may have "serious literary, artistic, political or scientific value." Finally, the Ordinance does not limit its reach to "hard core sexual conduct," though conceivably "hard core" materials may be included in its proscriptions.

Because the Ordinance spans so much more broadly in its regulatory scope than merely "hard core" obscenity by

limiting the distribution of "pornography," the proscriptions in the Ordinance intrude with defendants' explicit approval into areas of otherwise protected speech. Under ordinary constitutional analysis, that would be sufficient grounds to overturn the Ordinance, but defendants argue that this case is not governed by any direct precedent, that it raises a new issue for the Court and even though the Ordinance regulates protected speech, it does so in a constitutionally permissible fashion.

C. **Does established First Amendment law permit the regulation provided for in the Ordinance of otherwise protected speech?**

In conceding that the scope of this Ordinance extends beyond constitutional limits, it becomes clear that what defendants actually seek by enacting this legislation is a newly-defined class of constitutionally unprotected speech, labeled "pornography" and characterized as sexually discriminatory.

Defendants vigorously argue that *Miller* is not the "'constitutional divide' separating protected from unprotected expression in this area." (Defendants' Memorandum In Opposition To Plaintiffs' Motion For Summary Judgment, pp. 27-31). Defendants point to three cases which allegedly support their proposition that *Miller* is not the exclusive guideline for disposing of pornography/obscenity cases, and that the traditional obscenity test should not be applied in the present case. *See New York v. Ferber*, 458 U.S. 747, 102 S.Ct. 3348, 73 L.Ed.2d 1113 (1982); *FCC v. Pacifica Foundation*, 438 U.S. 726, 98 S.Ct. 3026, 57 L.Ed.2d 1073 (1978); *Young v. American Mini Theatres, Inc.*, 427 U.S. 50, 96 S.Ct. 2440, 49 L.Ed.2d 310 (1976).

Defendants first argue that the Court must use the same reasoning applied by the Supreme Court in *New York v. Ferber, supra*, which upheld a New York statute prohibit-

ing persons from promoting child pornography by distributing material which depicted such activity, and carve out another similar exception to protected speech under the First Amendment.

Defendants can properly claim some support for their position in *Ferber*. There the Supreme Court allowed the states "greater leeway" in their regulation of pornographic depictions of children in light of the State's compelling interest in protecting children who, without such protections, are extraordinarily vulnerable to exploitation and harm. The Court stated in upholding the New York statute:

> "The prevention of sexual exploitation and abuse of children constitutes a government objective of surpassing importance. The legislative findings accompanying passage of the New York laws reflect this concern: ...."

102 S.Ct. at 3355. The Supreme Court continued in *Ferber* by noting that the *Miller* standard for legal obscenity does not satisfy the unique concerns and issues posed by child pornography where children are involved; it is irrelevant, for instance, that the materials sought to be regulated contain serious literary, artistic, political or scientific value. In finding that some speech, such as that represented in depictions of child pornography, is outside First Amendment protections, the *Ferber* court stated:

> "When a definable class of material, such as that covered by §263.15, bears so heavily and pervasively on the welfare of children engaged in its production, we think the balance of competing interests is clearly struck and that it is permissible to consider these materials as without the protection of the First Amendment."

Id. at 3358.

Defendants, in the case at bar, argue that the interests of protecting women from sex-based discrimination are

analogous to and every bit as compelling and fundamental as those which the Supreme Court upheld in *Ferber* for the benefit of children. But *Ferber* appears clearly distinguishable from the instant case on both the facts and law.

As has already been shown, the rationale applied by the Supreme Court in *Ferber* appears intended to apply solely to child pornography cases. In *Ferber*, the court recognized "that a state's interest in 'safeguarding the physical and psychological well-being of a minor' is 'compelling.' *Globe Newspapers v. Superior Court*, ___ U.S. ___, ___, 102 S.Ct. 2613, 2621, 72 L.Ed.2d (1982)." 102 S.Ct. at 3354. *See also, FCC v. Pacifica Foundation, supra; Prince v. Massachusetts*, 321 U.S. 158, 168, 64 S.Ct. 438, 443, 88 L.Ed. 645 (1944); *Ginsberg v. New York*, 390 U.S. 629, 88 S.Ct. 1274, 20 L.Ed.2d 195 (1968). Also, the obscenity standard in *Miller* is appropriately abandoned in child pornography cases because it "[does] not reflect the State's particular and more compelling interest in prosecuting those who promote the sexual exploitations of children." *Id.* Since a state's compelling interest in preventing child pornography outweighs an individual's First Amendment rights, the Supreme Court held that "the states are entitled to greater leeway in the regulation of pornographic depictions of children." *Id.* at 3354.

On contrast, the case at bar presents issues more far reaching than those in *Ferber*. Here, the City-County Council found that the distribution, sale, and exhibition of words and pictures depicting the subordination of women is a form of sex discrimination and as such is appropriate for governmental regulation. The state has a well-recognized interest in preventing sex discrimination, and, defendants argue, it can regulate speech to accomplish that end.

But the First Amendment gives primacy to free speech and any other state interest (such as the interest of sex based equality under law) must be so compelling as to be

fundamental; only then can it be deemed to outweigh the interest of free speech. This Court finds no legal authority or public policy argument which justifies so broad an incursion into First Amendment freedoms as to allow that which defendants attempt to advance here. *Ferber* does not open the door to allow the regulation contained in the Ordinance for the reason that adult women as a group do not, as a matter of public policy or applicable law, stand in need of the same type of protection which has long been afforded children. This is true even of women who are subject to the sort of inhuman treatment defendants have described and documented to the Court in support of this Ordinance. The Supreme Court's finding in *Ferber* of the uncontroverted state interest in "safeguarding the physical and psychological well being of a minor" and its resultant characterization of that interest as "compelling," 102 S.Ct. 3348, 3354, is an interest which inheres to children and is not an interest which is readily transferrable to adult women as a class. Adult women generally have the capacity to protect themselves from participating in and being personally victimized by pornography, which makes the State's interest in safeguarding the physical and psychological well-being of women by prohibiting "the sexually explicit subordination of women, graphically depicted, whether in pictures or in words" not so compelling as to sacrifice the guarantees of the First Amendment. In any case, whether a state interest is so compelling as to be a fundamental interest sufficient to warrant an exception from constitutional protections, therefore, surely must turn on something other than mere legislative dictate, which issue is discussed more fully further on in this Opinion. *See* Section "C," *Infra.*

The second case relied upon by defendants to support their contention that *Miller* is not controlling in the present case is *FCC v. Pacifica Foundation*, 438 U.S. 726, 98 S.Ct. 3026, 57 L.Ed.2d 1073 (1978). According to defendants, *Pacifica* exemplifies the Supreme Court's refusal to make

obscenity the sole legal basis for regulating sexually explicit conduct.

In *Pacifica*, the Supreme Court was faced with the question of whether a broadcast of patently offensive words dealing with sex and excretion may be regulated on the basis of their content. 438 U.S. at 745, 98 S.Ct. at 3038. The Court held that this type of speech was not entitled to absolute constitutional protection in every context. *Id.* at 747, 98 S.Ct. at 3039. Since the context of the speech in *Pacifica* was broadcasting, it was determined only to be due "the most limited First Amendment protection." *Id.* at 748, 98 S.Ct. 3040. The reason for such treatment was twofold:

> "First, the broadcast media have established a uniquely pervasive presence in all the lives of all Americans. Patently offensive, indecent material presented over the airwaves confronts the citizen, not only in public, but also in the privacy of the home, where the individual's right to be left alone plainly outweighs the First Amendment rights of an intruder."
>
> * * *
>
> Second, broadcasting is uniquely accessible to children, even those too young to read..."

Id. at 748-49, 98 S.Ct. at 3040.

Although the defendants correctly point out that the Supreme Court did not use the traditional obscenity test in *Pacifica*, this Court is not persuaded that the rule enunciated there is applicable to the facts of the present case. The Ordinance does not attempt to regulate the airwaves; in terms of its restrictions, it is not even remotely concerned with the broadcast media. The reasons for the rule in *Pacifica*, that speech in certain contexts should be afforded minimal First Amendment protection, are not present here, since we are not dealing with a medium that "invades" the privacy of the home. In contrast, if an individual is offended by "pornography," as defined in the

Ordinance, the logical thing to do is avoid it, an option frequently not available to the public with material disseminated through broadcasting.

In addition, the Ordinance is not written to protect children from the distribution of pornography, in contrast to the challenged FCC regulation in *Pacifica*. Therefore, the peculiar state interest in protecting the "well being of its youth," *id.* at 649, 98 S.Ct. at 3040 (quoting *Ginsberg v. New York*, 390 U.S. 629, 33 S.Ct. 1274, 20 L.Ed.2d 195 (1968)), does not underlie this Ordinance and cannot be called upon to justify a decision by this Court to uphold the Ordinance.

The third case cited by defendants in support of their proposition that the traditional obscenity standard in *Miller* should not be used to overrule the Ordinance is *Young v. American Mini Theatres, Inc.*, 427 U.S. 50, 96 S.Ct. 2440, 49 L.Ed.2d 310 (1976). In *Young* the Supreme Court upheld a city ordinance that restricted the location of movie theatres featuring erotic films. The Court, in a plurality opinion, stated that "[e]ven though the First Amendment protects communication in this area from total suppression, we hold that the State may legitimately use the content of these materials as the basis for placing them in a different classification from other motion pictures." 427 U.S. at 71-72, 96 S.Ct. at 2452. The Court concluded that the city's interest in preserving the character of its neighborhoods justified the ordinance which required that adult theaters be separated, rather than concentrated, in the same areas as it is permissible for other theaters to do without limitation. *Id.* at 71, 96 S.Ct. at 2452-53.

Young is distinguishable from the present case because we are not here dealing with an attempt by the City-County Council to restrict the time, place, and manner in which "pornography" may be distributed. Instead, the Ordinance prohibits completely the sale, distribution, or exhibition of material depicting women in a sexually subordinate role, at all times, in all places and in every manner.

The Ordinance's attempt to regulate speech beyond one of the well-defined exceptions to protected speech under the first Amendment is not supported by other Supreme Court precedents. The Court must, therefore, examine the underlying premise of the Ordinance: that the State has so compelling an interest in regulating the sort of sex discrimination imposed and perpetuated through "pronography" that it warrants an exception to free speech.

C. Is sex discrimination a compelling state interest justifying an exception to First Amendment Protections?

It is significant to note that the premise of the Ordinance is the sociological harm, *i.e.*, the discrimination, which results from "pornography" to degrade women as a class. The Ordinance does not presume or require specifically defined, identifiable victims for most of its proscriptions. The Ordinance seeks to protect adult women, as a group, from the diminution of their legal and sociological status as women, that is, from the discriminatory stigma which befalls women *as women* as a result of "pornography." On page one of the introduction to defendants' *Amicus* Brief, counsel explicitly argues that the harm which underlies this legislation is the "harm to the treatment and *status* of women ... on the basis of sex." *See* Brief of Linda Marchiano *Amicus Curiae*, page 1 (emphasis supplied).

This is a novel theory advanced by the defendants, an issue of first impression in the courts. If this Court were to accept defendants' argument — that the State's interest in protecting women from the humiliation and degradation which comes from being depicted in a sexually subordinate context is so compelling as to warrant the regulation of otherwise free speech to accomplish that end — one wonders what would prevent the City-County Council (or any other legislative body) from enacting protections for other equally compelling claims against exploitation and discrimination as are presented here. Legislative bodies,

finding support here, could also enact legislation prohibiting other unfair expression — the publication and distribution of racist material, for instance, on the grounds that it causes racial discrimination,[2] or legislation prohibiting ethnic or religious slurs on the grounds that they cause discrimination against particular ethnic or religious groups, or legislation barring literary depictions which are uncomplimentary or oppressive to handicapped persons on the grounds that they cause discrimination against that group of people, and so on. If this Court were to extend to this case the rationale in *Ferber* to uphold the Amendment, it would signal so great a potential encroachment upon First Amendment freedoms that the precious liberties reposed within those guarantees would not survive. The compelling state interest, which defendants claim gives constitutional life to their Ordinance, though important and valid as that interest may be in other contexts, is not so fundamental an interest as to warrant a broad intrusion into otherwise free expression.

Defendants contend that pornography is not deserving of constitutional protection because its harms victimize all women. It is argued that "pornography" not only negatively effects [sic] women who risk and suffer the direct abuse of

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[2] In *Beauharnais v. Illinois*, 343 U.S. 250, 72 S.Ct. 725, 96 L.Ed. 919 (1952), the Supreme Court upheld an Illinois libel statute prohibiting the dissemination of materials promoting racial or religious hatred and which tended to produce a breach of the peace and riots. It has been recognized that "the rationale of that decision turns quite plainly on the strong tendency of the prohibited utterances to cause violence and disorder." *Collins v. Smith*, 578 F.2d 1197, 1204 (7th Cir. 1978). The Supreme Court has recognized breach of the peace as the traditional justification for upholding a criminal libel statute. *Beauharnais*, 343 U.S. at 254, 72 S.Ct. at 729. Therefore, a law preventing the distribution of material that causes racial discrimination, an attitude, would be upheld under this analysis. Further, the underlying reasoning of the *Beauharnais* opinion, that the punishment of libel raises no constitutional problems, has been questioned in many recent cases. *See Collins, supra*, 578 F.2d at 1205, and cases cited therein.

its production,[3] but also, those on whom violent pornography is forced through such acts as compelled performances of "dangerous acts such as being hoisted upside down by ropes, bound by ropes and chains, hung from trees and scaffolds or having sex with animals. . . ." Defendants' Memorandum In Support To Plaintiffs' Motion For Summary Judgment, pp.3-4.[4] It is also alleged that exposure to pornography produces a negative impact on its viewers, causing in them an increased willingness to aggress toward women, *ibid.* at p.4, and experience self-generated rape fantasies, increases in sexual arousal and a rise in the self-reported possibility of raping. *Ibid.* at p.6. In addition, it causes discriminatory attitudes and behavior toward all women. *Ibid*, at pp.11-12. The City-County Council, after considering testimony and social research studies, enacted the Ordinance in order to "combat" pornography's "concrete and tangible harms to women." *Ibid.* at p.13.

Defendants rely on *Paris Adult Theatre I v. Slaton*, 413 U.S. 49, 98 S.Ct. 2628, 37 L.Ed.2d 446 (1965), to justify their regulation of "pornography." In that case the Supreme Court held "that there are legitimate state interests at stake in stemming the tide of commercialized obscenity ... [which] include the interest of the public in the quality of life and the total community environment, the tone of commerce in the great city centers, and, possibly, the public safety itself." 413 U.S. at 57-58, 93 S.Ct. 2635.

The Georgia Legislature had determined that in that case exposure to obscene material adversely affected men

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[3] The defendants point to social research data, as well as graphic personal accounts of individuals, in support of their position that "women are recruited into all forms of sexual exploitation through physical force, psychological coercion, drugs and economic exigencies." Defendants' Memorandum In Support To Plaintiffs' Motion For Summary Judgment, p.2.

[4] Examples of these types of "harms" were submitted to the City-Council at the public hearings held in regard to the Amendment. *See* Exhibits A-U.

and women, that is to say, society as a whole. Although the petitioners argued in that case that there was no scientific data to conclusively prove that proposition, the Court said, "[i]t is not for us to resolve empirical uncertainties underlying state legislation, save in the exceptional case where that legislation plainly impinges upon rights protected by the constitution itself." *Id.* at 60, 93 S.Ct. at 2636-37 (footnote omitted).

In *Slaton*, the Georgia Legislature sought to regulate "obscenity," an accepted area of unprotected speech. *See Miller v. Cohen* [sic], 413 U.S. 15, 93 S.Ct. 2607, 37 L.Ed.2d 419 (1973). The Court specifically found that "nothing precludes the State of Georgia from the regulation of the allegedly obscene material exhibited in Paris Adult Theatre I or II, provided that the applicable Georgia law, as written or authoritatively interpreted by the Georgia courts, meets the First Amendment standards set forth in *Miller v. California*..." 413 U.S. at 69, 93 S.Ct. at 2642 (citations omitted).

Based on this reasoning, defendants argue that there is more than enough "empirical" evidence in the case at bar to support the City-County Council's conclusion that "pornography" harms women in the same way obscenity harms people, and, therefore, this Court should not question the legislative finding. As has already been acknowledged, it is not the Court's function to question the City-County Council's legislative finding. The Court's solitary duty is to ensure that the Ordinance accomplishes its purpose without violating constitutional standards or impinging upon constitutionally protected rights. In applying those tests, the Court finds that the Ordinance cannot withstand constitutional scrutiny.

It has already been noted that the Ordinance does not purport to regulate legal obscenity, as defined in *Miller*. Thus, although the City-County Council determined that "pornography" harms women, this Court must and does

declare the Ordinance invalid without being bound by the legislative findings because "pornography," as defined and regulated in the Ordinance, is constitutionally protected speech under the First Amendment and such an exception to the First Amendment protections is constitutionally unwarranted.[5] This Court cannot legitimately embark on judicial policy-making, carving out a new exception to the First Amendment simply to uphold the Ordinance, even when there may be many good reasons to support legislative action. To permit every interest group, especially those who claim to be victimized by unfair expression, their own legislative exceptions to the First Amendment so long as they succeed in obtaining a majority of legislative votes in their favor demonstrates the potentially predatory nature of what defendants seek through this Ordinance and defend in this lawsuit.

It ought to be remembered by defendants and all others who would support such a legislative initiative that, in terms of altering sociological patterns, much as alternation may be necessary and desirable, free speech, rather than being the enemy, is a long-tested and worthy ally. To deny free speech in order to engineer social change in the name of accomplishing a greater good for one sector of our society erodes the freedoms of all and, as such, threatens tyranny and injustice for those subjected to the rule of such laws. The First Amendment protections presuppose the evil of such tyranny and prevent a finding by this Court upholding the Ordinance.

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[5] Defendants again rely on *Young v. American Mini Theatres, Inc.*, 427 U.S. 50, 96 S.Ct. 2440, 49 L.Ed.2d 310 (1976), contending that since the legislation in that case was upheld upon a single affidavit of a sociologist that the location of adult movie theatres had a disruptive impact on the community, the Ordinance should be upheld because there is more than enough data to demonstrate that pornography harms women. As discussed above in subpart B, however, the legislation in *Young* sought to regulate the place where pornography could be distributed, not to completely ban its distribution. Thus *Young* is not controlling.

III.

FIFTH AMENDMENT DUE PROCESS REQUIREMETS

Assuming *arguendo* that the Court had found that the State has a compelling interest in preventing sex discrimination which interest outweighs First Amendment rights, there remain other constitutional requirements which the Ordinance must satisfy in ordei to be upheld. The Court must determine if the Ordinance is unconstitutionally vague, if it is facially overbroad, if it constitutes a prior restraint on free speech, or if it violates procedural due process safeguards. The Court, therefore, shall here address each of these issues as if it had found the Ordinance to be properly-regulated speech.

A. Vagueness

Plaintiffs contend the Ordinance is unconstitutionally vague, in that it fails to give fair notice of the material intended to be regulated. Plaintiffs challenge a long list of words and phrases on the grounds they are unconstitutionally vague:

"pornography"
"graphic sexually explicit subordination"
"subordination of women"
"sexual objects for domination, conquest, violation, exploitation, possession or use"
"postures or positions of servility, submission, or display"
"special display presentations of pornography"
"a woman acting against the subordination of women"
"in the way women are injured by it"
"forcing pornography on a person"
"directly caused by specific pornography"
"the use of men, children or transsexuals in the place of women,"
"unlawful"
"isolated passages or isolated parts"

(3)

No. 85-1080

Supreme Court, U.S.
FILED
JAN 21 1986
JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

October Term, 1985

SAN DIEGO GAS & ELECTRIC COMPANY,

Appellant,

v.

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, et al.,

Appellees.

On Appeal From The Supreme Court of California

MOTION TO DISMISS APPEAL OR AFFIRM BY APPELLEE, CITY OF SAN DIEGO

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Appellant,

v.

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, et al.,

Appellees.

On Appeal From The Supreme Court of California

MOTION TO DISMISS APPEAL OR AFFIRM BY APPELLEE, CITY OF SAN DIEGO

Pursuant to Rule 16 of this Court, appellee, The City of San Diego,[1] moves that the appeal herein taken be dismissed on the grounds that the judgment rests on an adequate nonfederal basis

[1] The City of San Diego was a party to the proceeding below and is therefore an appellee pursuant to Rule 10.4 of this Court. See, Appellant's Appendix ("Appendix"), pp. A-2 and A-27.

and the appeal does not present a substantial federal question; or, in the alternative, that the decision below be affirmed because the questions presented are so unsubstantial as not to merit further argument.

STATUTES AND CONSTITUTIONAL PROVISIONS

Appellant's Jurisdictional Statement adequately sets forth the appropriate statutes and constitutional provisions involved.

STATEMENT OF THE FACTS AND CASE

Appellant's statement of the case is misleading and inaccurate in numerous instances; however, for the most part, said inaccuracies relate to the merit of the issues and are irrelevant to the question of jurisdiction. Only a brief recitation of the salient facts is therefore appropriate.

In 1974 San Diego Gas & Electric Company ("SDG&E") entered into a long-term oil contract with Tesoro Alaskan Petroleum Company ("Tesoro"). Appendix, p. A-13. Effective January 1, 1979, SDG&E and Tesoro entered into a "Restated Agreement" which initially reduced SDG&E's oil obligation in 1979 and 1980 but increased deliveries in 1981, 1982 and 1983. *Id.* In Decision 91106, 2 CPUC 2d 572 (Dec. 19, 1979) the California Public Utilities Commission ("Commission") reviewed the record period January 1, 1979 through June 31, 1979 and specifically held over for later review all reasonableness issues other than certain rulings on oil sale losses. *Id.* at 577, 589-590. In Decision 91545, 3 CPUC 2d 503 (April 15, 1980) the Commission again specifically held over for later review all reasonableness issues for 1979 except as noted above. *Id.* at 503, 509-510.

Thereafter, the Commission did rule upon the reasonableness of certain other fuel related expenses by the Company during 1980,

1981 and 1982. In Application 83-07-16 (this case) the City of San Diego made an appearance as an interested party and argued that the reasonableness of the Restated Agreement had never been decided by the Commission and requested that the Company address that issue. Appendix, p. A-5. The Administrative Law Judge agreed and the issue was addressed at evidentiary hearings held for that application. *Id.* On February 1, 1984, the Commission issued Decision 84-02-005, an interim opinion, which upheld the ALJ's ruling that the Restated Agreement was at issue and further held that the agreement was unreasonable and that further hearings be held to determine the amount of a disallowance, if any. Appendix, pp. A-22 through A-25. Subsequently, evidentiary hearings were held to determine the appropriate disallowance. On December 5, 1984, the Commission issued Decision 84-12-026 which held that the appropriate disallowance should be $45,060,000 which was the amount that SDG&E paid to Tesoro not to receive fuel oil under the Restated Agreement for the record period then under review, July 1, 1982 to December 31, 1983. Appendix, pp. A-57, A-65. The Commission did not disallow any expenses incurred from January 1, 1979 to June 30, 1982. Appendix, p. A-28.

NATURE OF THE PROCEEDINGS BELOW

As SDG&E outlines in its Jurisdictional Statement, the ECAC procedure was adopted to account for recognition of up or down changes in the cost of fuel and energy. *See e.g., City of Los Angeles v. Public Utilities Commission*, 15 Cal.3d 680, 695-696 (1975). Reviews of the reasonableness of operations for a prior "record period" occur for the utility and only reasonable fuel costs, reasonably incurred, are recovered. Decision 92496, 4 CPUC 2d 693, 700-701 (Dec. 5, 1980). During that review, the Commission reviews the reasonableness of fuel oil contracts. *Id.* at 700.

In evidentiary hearings that take place before an Administrative Law Judge, the utility has the burden to prove the reasonableness of its fuel related expenditures with clear and convincing evidence. The reason for this rule is sound. The utility is the sole party in possession of evidence concerning the prudency of its past actions. Decision No. 83-10-001 (1983), at page 3. No other party to the proceeding has similar access to the evidence. Consequently, the utility must prove that its actions were reasonable, and it is not for the Commission, the staff, or any other party to prove to the contrary.[2] *Id.*; Decision 65210, 60 CPUC 183 (1962).

It is important to note that SDG&E does not challenge the validity of the ECAC procedure nor contend that the Commission had no authority to make rules or retain jurisdiction, for later review, of the reasonableness of fuel expenses for the 1979 period.

ARGUMENT

An important perspective to maintain throughout a review of the questions presented by SDG&E is that SDG&E is a public utility in Southern California providing essentially monopoly service to its ratepayers. It is uncontested below that SDG&E paid Tesoro some $45,000,000 *not* to take oil it had contracted for under the Restated Agreement. It is this sum that SDG&E seeks to recover from its ratepayers despite the fact that the ratepayers would be paying for a commodity that would not provide them with any benefit.

Finally, SDG&E cannot contend it was not given a hearing and opportunity to present evidence as required under California law. The Commission has made proper findings and followed all statutory requirements. Absent a clear showing that the limits of

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[2] Throughout the Jurisdictional Statement, SDG&E seeks to shift this burden of proof by stating that no evidence was presented to the Commission to show that the Restated Agreement was unreasonable in various respects. This Court should remember that SDG&E had the burden to show its action reasonable.

due process have been overstepped, this Court should not intervene. *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1941). SDG&E has failed to make such a showing here.

I

THE QUESTIONS PRESENTED ARE NOT SUBSTANTIAL

The federal questions presented must be substantial in order for this Court to exercise jurisdiction over an appeal. *Palmer Oil Corp. v. Amerada Corp.*, 343 U.S. 390, 391 (1951). Here SDG&E appeals on the ground that a decision of the California Public Utilities Commission is repugnant to the Constitution of the United States in several respects. A brief review of the questions raised will reveal that they are not substantial and do not warrant further argument.

A

SDG&E WAS NOT DENIED DUE PROCESS BY THE "PERSPECTIVE" OF THE COMMISSION DECISION

SDG&E's argument on this point, at Jurisdictional Statement p. 12 *et seq.*, is totally devoid of any statutory or decisional law to support its contention that the "perspective" of the Commission decision somehow denied them due process. That fact alone indicates that the point raised is not a substantial federal question.[3]

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[3] To the extent that SDG&E cites decisions of the Commission, such arguments raise issues of state law interpretation, not federal, and should not invoke the jurisdiction of this Court.

In addition, however, reference to the Commission decision shows that the Commission did in fact review the Restated Agreement in light of the conditions which existed at the time of its formation. For example, in discussing the flexibility of the HIRI fuel oil contract option, the Commission looked at SDG&E's own calculations of fuel oil availability, *known to SDG&E at that time*, and determined the economic benefit of the Agreement based on information also available to SDG&E at that time. Appendix at pp. A-15 and A-16. Additionally, the Commission found that SDG&E was, at the time it entered into the Restated Agreement, attempting to avoid an assessment of a $1/bbl penalty on rejected natural gas. *Id.* at A-17. *See also*, A-18 through A-21. It is clear therefore that the Commission took into consideration the facts apparent to SDG&E at the time of the Restated Agreement. No substantial federal question is thus raised on this issue.

B

SDG&E WAS NOT DENIED DUE PROCESS BECAUSE SUFFICIENT UNCHALLENGED CONCLUSIONS AND FINDINGS EXIST TO SUPPORT THE DECISION

SDG&E states that the Commission decision holding the Restated Agreement unreasonable rests on only three grounds. Appellant's Jurisdictional Statement at p. 17. Appellant either misunderstands or misstates the appropriate decision of the Commission. In its interim decision, the Commission makes four separate conclusions why the Restated Agreement was unreasonable and makes nine separate findings of fact to support those conclusions. Appendix, pp. A-23 to A-25. The four cited conclusions are:

> 1. SDG&E was unreasonable in entering the 1979 Restated Agreement with Tesoro because at that time the perceived benefits did not outweigh

the risks shown in the utility's own economic analysis.

2. SDG&E was unreasonable because the utility failed to conduct adequate studies before entering into the 1979 Restated Agreement.

3. SDG&E was unreasonable because the utility attempted to shield the shareholders from Commission penalties and the short-term carrying costs of excess LSFO inventory at the long-term expense of the ratepayers.

4. SDG&E was unreasonable because the utility failed to adequately consider the possibility that greater quantities of natural gas than were forecast would become available despite its past experience in understating gas availability.

The cited findings are:

13. At the time SDG&E entered into the 1979 Restated Agreement, the utility projected fuel savings of just $500,000 from the agreement.

14. The 1979 Restated Agreement eliminated the flexibility in contract volumes SDG&E had in the HIRI contract and substituted an inflexible take-or-pay obligation to Tesoro.

15. The utility's economic analysis showed the 1979 Restated Agreement reduced the probability of excess LSFO in 1979 and 1980 but increased the probability of excess LSFO in 1981 and 1982.

16. At the time SDG&E entered into the 1979 Restated Agreement, the perceived benefits did not

outweigh the risks shown in the utility's own analysis.

17. SDG&E was preoccupied with the possibility of a $1/bbl penalty for rejecting cheaper natural gas when it entered the 1979 Restated Agreement.

18. SDG&E entered into the 1979 Restated Agreement [*sic*] to shield its shareholders from the carrying costs of an excess LSFO inventory in 1979 and 1980.

19. SDG&E did not conduct adequate studies before entering into the 1979 Restated Agreement.

20. SDG&E did not follow the recommendations of the Gilbert Report before entering into the 1979 Restated Agreement.

21. At the time SDG&E entered into the 1979 Restated Agreement, the utility had not considered the possibility that more natural gas would be available than was forecast even though the utility's gas forecasting methodology had consistently understated the volumes of natural gas that became available in 1975, 1976, 1977, and 1978.

In its Jurisdictional Statement, SDG&E attacks only one of the conclusions (No. 1 above) and two of the findings (Nos. 14 and 16). Appellant's Jurisdictional Statement at pp. 16-21. Even if conclusion No. 1 and finding Nos. 14 and 16 were not supported by substantial evidence, this Court should conclude that the decision below is supported by the other conclusions and findings,

which remain unchallenged,[4] and thus the decision does not raise a substantial federal question.

In any event, evidence does exist in the record to support the challenged findings and conclusions.

1. THE FLEXIBILITY OF THE HIRI CONTRACT IS SUPPORTED BY THE EVIDENCE

SDG&E misstates the Interim decision (Decision 84-02-005) below when it states, at page 19 of the Jurisdictional Statement, that the Commission found that SDG&E could rely on anywhere from 14,000 barrels of oil a day (bbl/day), from HIRI, to 28,800 bbl/day. The decision, at page A-15, correctly states that SDG&E could have increased HIRI volumes from 14,000 bbl/day to 28,800 bbl/day. Thus, when the decision states that the range was from 5.1 million bbl/year to 10.5 million bbl/year that statement correctly reflects the HIRI option. It is that flexibility the Commission relied upon. SDG&E had a choice of receiving either of the two volumes. This did in fact represent flexibility that SDG&E chose to ignore. Contrary to there being no evidence on that point, therefore, SDG&E admits that the flexibility the Commission refers to was there.

As to Amendment 7 of the HIRI contract, SDG&E does not contend that the HIRI contract was not in evidence at the hearings.[5] It logically follows that Amendment 7, being part of the contract, was properly before the Commission for consideration.

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[4] Since SDG&E does not challenge the other findings and conclusions, this Court should decline to review them. *Grayson v. Harris*, 267 U.S. 352, 358 (1924).

[5] That it was is reflected in the discussion at p. A-15 of the Appendix.

2. EVIDENCE EXISTS TO SUPPORT THE CONCLUSION THAT THE RISKS OF THE RESTATED AGREEMENT OUTWEIGHED THE PERCEIVED BENEFITS.

SDG&E makes only several conclusory statements in regard to the above argument. Jurisdictional Statement at p. 20. Contrary to those statements, a review of the decision, at pages A-13 through A-21 of the Appendix, clearly shows a detailed analysis of the evidence presented which supports the conclusion.

C

SDG&E WAS NOT DENIED DUE PROCESS BY THE ABSENCE OF A FINDING OF APPROPRIATE ALTERNATIVE ACTION

As noted, *supra*, the burden was upon SDG&E to show the reasonableness of its actions. Having failed to do so, the Commission provided SDG&E an opportunity to present evidence establishing the "actual consequences" of the Restated Agreement for purposes of determining a proper disallowance. Appendix at p. A-22. SDG&E, however, took the opportunity to attempt to relitigate the reasonableness of the Restated Agreement. The Commission reviewed some of SDG&E's proffered evidence and properly determined that such was the case. Appendix at pp. A-59 through A-63.

Here, SDG&E does not argue that the Commission had not the power to make such determinations nor exclude such evidence. This it clearly has the power to do. California Constitution, Art. XII, Sections 2 and 6. SDG&E merely disagrees with the Commission's conclusion with respect to what the proffered evidence tended to show. Such factual disagreements are not for review by this Court. *Grayson v. Harris*, 267 U.S. 352, 358 (1924). The review and exclusion of that evidence, therefore, does not raise a substantial federal question.

D

SDG&E WAS NOT DENIED DUE PROCESS BY THE COMMISSION DECISION TO REVIEW THE RESTATED AGREEMENT

SDG&E does not argue that the Commission does not have the power to retain jurisdiction to review, at a later time, the reasonableness of utility actions. The California Commission clearly did so in this case.

The 1979 Restated Agreement, effective January 1, 1979, was to have been reviewed at the end of the appropriate record period, January 1 - July 31, 1979. The Commission, in Decision 91106, 2 CPUC 2d 572 (Dec. 19, 1979) specifically held open for later review those reasonableness issues. *Id.* at 577, 589-590. In the next review period, Decision 91545, 3 CPUC 2d 503 (April 15, 1980), the Commission again specifically held over for later review the reasonableness of fuel expenses for the entire year (January 1 - December 31, 1979). *Id.* at 503, 509-510. As noted previously, the Commission did rule upon certain reasonableness issues but not the Restated Agreement.

The crux of SDG&E's argument is that because the Commission found expenses from January 1, 1980 - June 31, 1982 reasonable, that determination somehow implies a finding of reasonableness in 1979. Nothing is further from the truth!

The California Supreme Court has long recognized that the findings of fact and conclusions of law necessary in Commission decisions be adequately supported by the evidence and that such findings and conclusions cover points material to the decision. *City of Los Angeles v. Public Utilities Commission*, 7 Cal.3d 331, 349 (1972).

SDG&E has not shown that any previous findings of fact or conclusions of law of the Commission held that the 1979 Restated

Agreement was reasonable. On the contrary, as previously noted, the Commission specifically retained jurisdiction over reasonableness issues for 1979. This Court, therefore, should decide that the reasonableness of the 1979 Restated Agreement was never litigated or decided by the Commission and was properly before it in this case.[6]

II

THE DECISION BELOW RESTS ON ADEQUATE NON-FEDERAL GROUNDS

Where the highest court of a state fails to deliver an opinion in a case in which the federal issues are properly presented, it is presumed that the decision below rests on adequate non-federal grounds. *Phyle v. Duffy*, 334 U.S. 431, 281 (1947). Here, SDG&E's Jurisdictional Statement raises mostly questions regarding the interpretation of factual issues decided by the Commission. Such factual review of state court decisions is normally not a function of this Court. *Grayson v. Harris, supra*. There being, as argued previously, sufficient evidence to support the conclusions of the Commission, questions concerning the resolution of disputed facts in one for state courts[7] and thus provides an adequate non-federal ground to support the decision below. Absent a showing by SDG&E that this state ground cannot account for the decision, jurisdiction should be declined. *Durley v. Mayo*, 351 U.S. 277, 281 (1955). SDG&E has not made such a showing here.

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[6] As noted in footnote 2, *supra*, this Court should not allow SDG&E to shift its burden of proof onto other parties. SDG&E never showed the reasonableness of the Restated Agreement, which it had the burden to do.

[7] The California Supreme Court has held that findings of fact by the Commission are similar to jury verdicts and are to be accorded similar treatment on review. *Toward Utility Rate Normalization v. Public Utilities Commission*, 22 Cal.3d 529, 537 (1978).

CONCLUSION

Appellant, SDG&E, has not presented any compelling arguments why the questions it raises are substantial or why the decision below does not rest on adequate non-federal grounds. Appellant merely disagrees with the findings and conclusions of the Commission as to its reasonableness in entering into the Restated Agreement. The Commission gave appellant the opportunity to present evidence and to be heard on the issue. There is no reason for this Court to exercise its jurisdiction in this case to decide questions purely within the competence of the Commission and California Supreme Court to decide. The appeal below should be dismissed or the decision below affirmed.

Dated: January 21, 1986

Respectfully submitted,

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Supreme Court, U.S.
FILED
JAN 22 1986
JOSEPH F. SPANIOL, JR
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(4)

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On Appeal from the Supreme Court of California

MOTION TO DISMISS

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No. 85-1080

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

SAN DIEGO GAS & ELECTRIC COMPANY,
Appellant,

v.

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,
Appellee.

On Appeal from the Supreme Court of California

MOTION TO DISMISS

The Appellee (the Commission), respectfully moves the Court to dismiss the appeal herein, on the ground that the appeal does not present a substantial federal question.

I

OPINIONS BELOW

The opinions below are correctly stated in the Appellant's (SDG&E's) Jurisdictional Statement.

II

JURISDICTION

Jurisdiction is asserted by SDG&E under Title 28, United States Code Section 1257(2). (Jur. St. 1.)[1]

[1] Reference herein to the Appendix (App.) is to that attached to the Jurisdictional Statement. "Jur. St." followed by a number refers to pages of the text of the Jurisdictional Statement.

III

STATEMENT OF THE CASE

The Appellant, the San Diego Gas & Electric Company (SDG&E), petitions this Court for review of two Commission decisions issued in a proceeding, held pursuant to the energy cost adjustment clause mechanism, to review the reasonableness of SDG&E's recorded fuel costs for the period July 1, 1982 to April 30, 1983. The first of those decisions found SDG&E to have been unreasonable in entering into a long term low sulfur fuel oil contract with the Tesoro Alaskan Petroleum Company (Tesoro); the second decision ordered SDG&E to refund to its ratepayers $45 million in costs resulting from that unreasonableness which the Commission found to be more appropriately assumed by SDG&E's shareholders. In each case, the Commission's decision was made after SDG&E had been given a full opportunity to present evidence sufficient to sustain its burden of proof. In each case, after considering the evidence presented, the Commission concluded SDG&E had failed to meet its burden.

While its conclusions are simply put, this proceeding arose in a much more complex context.

Purpose and Operation of the Energy Cost Adjustment Clause Mechanism

In 1972, the Commission adopted fuel cost adjustment tariff provisions for each of the major electric utilities under its jurisdiction. Prior to this time, such costs had been considered only in general rate cases. These adjustment provisions were designed to forestall the increasingly frequent large over- or undercollections resulting from unanticipated fluctuations in utilities' fuel costs. They provided a considerable measure of revenue stability to the utilities which the general rate case format did not.

The original fuel cost adjustment provisions were replaced in 1975 by the energy cost adjustment clause (ECAC) mechanism, which was further refined in 1980. In current practice, a utility may apply for an adjustment under ECAC every six months.

As the quid pro quo for an automatic pass-through to ratepayers of forecasted fuel costs every six months, the ECAC mecha-

nism provides for an annual review of the reasonableness or prudency[2] of a utility's fuel costs, the "record period" for review being the twelve months ending as of the previous revision date. Were it not for such review, the reasonableness of a utility's fuel costs would go unexamined.

This review is held concurrent with one of the six month adjustment proceedings. The Commission here examines the reasonableness of all recorded fuel costs incurred during the twelve months of the particular review period at issue. In the course of this review, any costs found to have been unreasonably incurred are disallowed from rates. As a rule, the Commission does not consider adjustments beyond the specific review period; however, certain specific costs and issues related thereto can be reserved for later consideration. The contract at issue in the instant case was specifically reserved in this way.

History of This Proceeding

A. SDG&E's Fuel Procurement Policies and Long-Standing Oversupply Problem of the Late 1970's

SDG&E's ultraconservative fuel procurement policies of the early 1970's resulted in chronic low sulfur fuel oil (LSFO) oversupply toward the end of that decade. The company's mistaken assessment of its fuel oil needs over a period of years led to added cost burdens for its ratepayers, particularly the burden of sales—at a loss—of purchased oil, and underlift payments to suppliers for contracted oil that an oversupplied SDG&E could not use. This fuel oversupply problem also at times affected SDG&E's flexibility to use natural gas when that fuel was available as a cheaper alternative.

By the late 1970's, the company had already amassed a considerable record of fuel oil sale losses, occasioned by having to sell some of its excess oil. In Decision (D.) 88225, 83 Cal.P.U.C. 142, issued December 13, 1977, the Commission first addressed this problem in some depth. The Commission found SDG&E to have suffered a net fuel oil sale loss of $4.7 million. In that case,

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[2] The Commission has used these terms interchangeably.

the Commission expressed reservations about SDG&E's fuel procurement policies and ordered SDG&E to hire a consultant to assess them. In addition, the Commission ordered SDG&E to:

> "... develop an extensive record [in the next and future ECACS] on fuel procurement policies and practices, which shall reflect improvements already initiated as well as plans for future improvement." 83 Cal.P.U.C. at 148; Ordering Para. 3.

In D. 89630, 84 Cal.P.U.C. 596, issued November 9, 1978, the Commission found further oil sale losses of nearly $1 million had been incurred. The consultant's study, called the Gilbert Report, was by this time completed. The Commission deferred the issue of how to treat the oil sale losses until the next ECAC proceeding.

Further review of the Gilbert Report was undertaken in proceedings leading to D. 90404, 1 Cal.P.U.C. 2d 596, issued June 5, 1979. While the Report concluded SDG&E's fuel policies had not been imprudent, it criticized those policies in several particulars and urged remedial changes. The weaknesses all stemmed from SDG&E's early and virtually exclusive reliance on LSFO as a fuel source. Most relevant to the instant case was the problem of lack of documentation or adequate alternative studies to support SDG&E's actions on oil sales, procurement, inventory and contract amendments. 1 Cal.P.U.C. 2d at 639. The Report recommended that because "contract provisions are of extreme importance[,] [a]ll contract changes, adjustments and verbal agreements should be documented and confirmed by studies and correspondence for future reference and audit purposes." 1 Cal.P.U.C. 2d at 640-641. Moreover, "[c]lear levels of authority for purchases and negotiation of contract changes, exchanges, and sales have not been delineated." *Id.* at 641. The Report recommended "a review of the organizational placement of the Fuel Resources Department in six months," the primary concern being "the continuing requirement to develop corporate strategy [on] fuels at an executive level where all relevant alternatives can be examined." *Id.* at 641-642. The Report further recommeded preparation of a formal fuel procurement plan, and expansion of the fuel planning process to formally review and forecast future

market conditions as an aid to decisionmaking on long-term oil contracts. *Id.* at 642-643.

The Commission agreed that while SDG&E had not been imprudent, its fuel policies were ultraconservative and reactive, and its current practices needed modification in several crucial respects. The Commission resolved the issue of the oil sale losses which had been deferred by disallowing from ECAC recovery, as against ratepayers' interests, some $3.5 million of the $5 million incurred.

Throughout this period, SDG&E's primary fuel oil suppliers were Tesoro and the Hawaiian Independent Refinery, Inc. (HIRI). SDG&E had initially contracted with Tesoro in 1974, and by 1979 had gone through three amendments to the original contract. The 1979 amendment, termed the 1979 Restated Agreement (Restated Agreement), reduced SDG&E's LSFO takes under the contract by 3,000 barrels per day (bbls/d) for 1979 and 1980. But importantly, it also increased takes for 1981, 1982 and 1983, by 8,000 bbls/d, 16,000 bbls/d, and 7,000 bbls/d respectively. It is this Restated Agreement which is the subject of the instant case.

The Commission did not review the Restated Agreement for reasonableness at the time it was entered into. Coincident with that time, the Commission had initiated a generic investigation of the ECAC mechanism. While the reasonableness of the Restated Agreement was originally included in the above issues, it was not resolved until the case at bar.

Meanwhile, the world fuel supply picture continued to evolve. The greatly increased availability of inexpensive natural gas was the most significant factor for SDG&E and its ratepayers. Its oil oversupply problem radically affected its ability to use that gas as a cheaper alternative. As stated above, its Restated Agreement with Tesoro *increased* its fuel oil contract commitment for 1981, 1982, and 1983. In addition, it had to refuse cheaper natural gas to avoid inventory beyond its capacity, and had, by the end of 1981, incurred another $7 million in losses through sale of excess oil. See D. 82-04-115, 9 Cal.P.U.C. 2d 1, 10-15 (1982). By mid-

1981, as testified to in the instant case, even SDG&E realized that its forecast of limited gas availability was in error.

B. Events Leading Up To the Instant Case

Finally, in April 1982, the Commission issued an order to show cause (OSC) directing SDG&E to demonstrate why the Commission should not require the utility to suspend or reduce deliveries of residual fuel oil scheduled under existing contracts with its two suppliers, Tesoro and HIRI. Testimony in SDG&E's then-ongoing ECAC proceeding gave the Commission reason to believe that SDG&E had contract commitments to purchase 3,500 barrels a day of oil over and above its forecasted requirements, with no sign that SDG&E intended to do anything about amending its contracts. Furthermore, both of SDG&E's contracts had *force majeure* provisions which appeared to excuse performance under only two conditions: an act of God or a governmental order to reduce or suspend deliveries.

SDG&E's reply to the OSC admitted that its oil supply exceeded requirements by 10,000 bbls/d, but asserted it was negotiating with Tesoro to reduce deliveries by 6,000 bbls/d. The decision in the ECAC case, issued a day prior to SDG&E's filing its reply to the OSC, found SDG&E's procurement policies both unimaginative and unrealistic, appearing "to be driven by its oil contract obligations rather than by reasonable projections of need and reliability." D. 82-04-115, *supra*, 9 Cal.P.U.C. 2d at 21. The Commission set SDG&E's oil inventory level (one of the items established in an ECAC proceeding) such that SDG&E had to reduce its oil supply by about 15,000 bbls/d or face a shareholder penalty of 50% of the carrying costs of the excess inventory. Moreover, the Commission warned SDG&E that continuation of its oil oversupply was "of such a serious nature that SDG&E is placed on notice that we will consider a penalty in future ECAC annual reviews if SDG&E fails to relieve the excess oil and gas rejection problems in the reasonably near future. SDG&E's ratepayers will not be forced to continue to underwrite the status quo." *Id.* at 23.

SDG&E finally worked out a tentative agreement with Tesoro for the latter to suspend all deliveries from October 1, 1982 to

December 31, 1983. A condition precedent for this agreement to be signed by Tesoro was that the Commission drop the OSC. The Commission did so, but stated that such action did not constitute a finding on the reasonableness of this latter agreement, called the Suspension Agreement, or any charges to be incurred by SDG&E because of it.

The reasonableness of this Suspension Agreement was an issue in the instant case. Prior to resolving the issue as noted below, the Commission allowed $45 million in underlift charges which, under the terms of the Suspension Agreement, SDG&E had to pay to Tesoro, to be recovered, *subject to refund,* under ECAC.

C. The Instant Case

Early in the course of the twenty-nine-day evidentiary hearings in the instant case, the City of San Diego (City) moved that the Commission should be reviewing not only the reasonableness of the Suspension Agreement, but of the 1979 Restated Agreement which had established SDG&E's residual oil contract requirements through 1983, and which had been the subject of the Commission's OSC. The Administrative Law Judge (ALJ) granted the City's request, thus the reasonableness of the Restated Agreement also became an issue in the case.

Under protest, SDG&E produced a witness to testify as to the reasonableness of the Restated Agreement, after its motion to overturn the ALJ's ruling sustaining the relevancy of this issue had been denied. During the hearings, the ALJ took official notice of the Gilbert Report. Testimony was also presented by SDG&E and the Commission staff on the issue of the reasonableness of the subsequent Suspension Agreement.

SDG&E's witness on the subject of the Restated Agreement was not one of the negotiators of the Restated Agreement and had not ever read it, although he signed it for the company. Reporter's Transcript (R.T.) 2717, 2732. He knew only vaguely of studies, not directly relating to Tesoro, which may have had some indirect impact on SDG&E's view of the reasonableness of the Agreement. R.T. 2737. He was uncertain whether the Company considered any but a few very limited alternatives to the Agreement, and had not provided the Commission with any such studies or

alternatives in the instant proceeding. R.T. 2737-2743. After consideration of this direct testimony and extensive cross examination by staff and the City, the Commission issued the Interim Opinion, D. 84-02-005. This decision, *inter alia*, found SDG&E to have been unreasonable in entering into the Restated Agreement, for several interrelated reasons.

From the evidence presented, the Commission concluded that SDG&E had given up a more flexible oil supply situation for a less flexible option which provided, at most, marginal benefits; that SDG&E was motivated largely by the short-term benefits the Restated Agreement could provide to its shareholders at the long-term expense of its ratepayers; and that despite serious criticisms of SDG&E's fuel procurement practices as set forth in the Gilbert Report, SDG&E continued those practices by making the decision to enter the Restated Agreement without having adequately analyzed the long-term risks and liabilities this contract posed. See D. 84-02-005, App. A13-A21; Findings 12-21; Conclusions 1-4, App. A23-A25. As a consequence of all this, the Commission found the issue of reasonableness of the Suspension Agreement moot. The Interim Opinion deferred the issue of a possible disallowance to a further decision, pending receipt of additional evidence on the "actual consequences" of the Restated Agreement, and the financial impact on SDG&E of a disallowance. SDG&E then filed a timely application for rehearing.

At the beginning of the disallowance phase, the Commission staff argued that much of the testimony prepared by SDG&E for this phase relitigated issues already decided in the Interim Opinion and moved to exclude this testimony. The City joined in the staff's motion. SDG&E replied that it was not attempting to relitigate issues already resolved, and requested leave to submit by letter legal authorities supporting its position on the appropriate measure of damages. After reviewing letter briefs submitted by all the parties on the relevant legal authorities, the ALJ, supported by the Commissioner assigned to the proceeding, issued a ruling excluding most of the testimony. Further hearings commenced in early April, 1984.

The Commission issued the Final Opinion, D. 84-12-026, on December 5, 1984. After setting forth in detail the positions of the

parties and analyzing their strengths and weaknesses, this decision found, *inter alia*, that a disallowance of up to $70 million would have little adverse financial impact on SDG&E after 1984, that the parties had presented various different disallowance figures ranging from $97 million to $4.55 million based on different ways of measuring the actual consequences of the Restated Agreement, and that a disallowance of $45 million was the most appropriate and the most equitable. The decision also agreed with the ALJ that SDG&E had attempted to relitigate issues resolved by the Interim Opinion. See D. 84-12-026, App. A34-A43, A46-A59.

Finally, the decision discussed once again the Commission's original conclusion that the Restated Agreement was unreasonable in light both of SDG&E's claim that the Interim Opinion had found only SDG&E's procedures and motivations to be unreasonable but not the Restated Agreement itself, and its further claim that the HIRI contract offered no flexibility. After rejecting the first claim out of hand, the decision discussed at length additional evidence taken in the disallowance phase which wholly confirmed the earlier conclusions on the HIRI contract. App. A59-A63.

SDG&E filed a timely application for rehearing of D. 84-12-026. Both of its applications were denied in D. 85-04-111, which modified and clarified D. 84-12-026 but did not change the result. SDG&E then filed a petition for writ of review with the California Supreme Court. By its order of September 24, 1985, that Court unanimously rejected SDG&E's claims on the merits, without the necessity of hearing further argument.

ARGUMENT

SDG&E'S DUE PROCESS CLAIM IS INSUBSTANTIAL

I. SDG&E Has Presented No Overriding Reason Why This Court Should Grant Review

A. Denial of Review By the California Supreme Court Does Not Justify Review By This Court

SDG&E appears to argue that the California Supreme Court's unanimous rejection of SDG&E's petition for writ of review without issuing a writ deprives it of the serious appellate review to

which it is entitled. Jur. St. 9-10, 28. Nothing could be further from the truth. Over 20 years ago, the California Supreme Court held in *People v. Western Air Lines, Inc.*, 42 Cal.2d 621, 630, 268 P.2d 723, *appeal dismissed*, 348 U.S. 859 (1954) that summary denial of a petition for writ of review of a Commission order is a decision on the merits as between the parties, on all questions of fact and law presented in the petition. The California Court has consistently followed this principle and has recently reaffirmed it in *Consumers Lobby Against Monopolies v. Public Utilities Comm.*, 25 Cal.3d 891, 901, 160 Cal.Rptr. 124, 603 P.2d 41 (1979).

The California Legislature has made the California Supreme Court the sole forum for appellate review of Commission decisions. California Public Utilities Code Section 1759; see also Sections 1756-1758, 1760. It must be presumed that the California Court knows it is the sole forum and that its orders denying review are conclusive on all factual and legal questions presented. Accordingly, it must also be presumed that its denial without issuing a writ is only done after serious consideration and with full awareness of the legal impact of its decision.

In the instant case, the clear import of the Court's order is that SDG&E failed to set forth sufficient grounds to warrant plenary treatment. Implicit in that order is the finding that the Commission's decisions were fully consistent with both state law and federal due process requirements. *People v. Western Airlines, supra; Consumers Lobby, supra.*[3] The Court's summary denial of review has not denied SDG&E appellate review or any other aspect of due process.

B. SDG&E's Attempt to Link This Case With Other Prudency Reviews is Misplaced

SDG&E attempts to magnify the significance of this case by asserting it is connected to other fuel cost adjustment cases and

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[3] Inasmuch as none of the procedural defects discussed in the *Consumers Lobby* opinion, 25 Cal.3d at 902-905, is pertinent to the instant case, denial of SDG&E's petition could only have been for want of substantive merit.

major plant addition applications now before the Commission, and even before other commissions across the country. SDG&E argues that the constitutional infirmities purportedly raised by the case at bar, if allowed to go uncorrected, will present substantial barriers to utilities in these other cases. SDG&E's attempt to link these cases is inaccurate and misleading.

The Commission has been conducting reasonableness reviews of utility fuel costs for the last ten years. These cases are not dependent on or related to each other except for general policy direction. They all depend for their outcome, as does any rate case, on the particular facts before the Commission. SDG&E admits it does not protest either the ECAC mechanism or the Commission's standard of reasonableness, but rather only the application of that standard to the facts of this case. Jur.St. 13.

Prudency reviews of major utility plant additions are even further removed. Such cases involve review of the reasonableness or prudency of a utility's investment in a major new plant which has just or will soon become operational, e.g., the $6.0 billion investment in the Diablo Canyon Nuclear Project, prior to inclusion of any of that investment in the utility's rate base. Only prudent investment costs will be allowed. These reviews were at one time conducted as part of a utility's general rate case. However, the amounts of money at stake and complexity of the issues raised have increased so dramatically for many of these major projects that it has become essential to review the reasonableness of the utilities' investment costs in separate proceedings. This, however, does not connect these cases with SDG&E's case, any more than if they were still part of general rate cases.

Again, the outcome of each case will be dependent on its own facts. None of the cases referred to by SDG&E involves facts even remotely similar to those of the case at bar. The only similarity between the two types of cases is that they both look back to expenses already incurred or investment already made, and do not set rates prospectively. That is where the similarity ends.

SDG&E has not shown how this case, decided on its own facts, will have any impact whatsoever on any other party's due process

rights in any other case before this Commission or other commissions in other jurisdictions.

II. The Jurisdictional Statement Raises No Substantial Due Process Question

Although its arguments are less than clear, SDG&E appears to attack the Commission's decision as violating due process on the four following grounds: 1) the Commission impermissibly used hindsight in judging SDG&E's actions; 2) the Commission's finding of imprudence was not supported by substantial evidence; 3) the Commission failed to find a reasonable alternative and rejected SDG&E's evidence relative thereto; and 4) since the $45 million disallowance is unfair, the Commission should be estopped from imposing it.

In raising these arguments, SDG&E does nothing more than reargue the facts of this case. SDG&E would have this Court substitute its judgment for that of the Commission in assessing the evidence presented. That is a role which this Court has repeatedly declined to play. In suits involving the validity of rates[4] set by a state commission, this Court will not sit as a board of revision, but will concern itself only with whether constitutional rights have been violated. *Railroad Commission v. Pacific Gas & Electric Co.*, 302 U.S. 388, 393 (1938); *Los Angeles Gas & Electric Corp. v. Railroad Comm.*, 289 U.S. 287, 304-305 (1933).

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[4] Although procedurally SDG&E appears to characterize this case as something other than a ratemaking matter (Jur.St. 4, 10), a reasonableness review of a utility's fuel costs is clearly a part of the Commission's ratemaking responsibility, and has long been recognized as such by the California Supreme Court. See *Southern California Edison Co. v. Public Utilities Comm.*, 20 Cal.3d 813, 144 Cal.Rptr. 905, 576 P.2d 945 (1978). It *is* different from prospective general rate cases in that fuel-related costs are passed on to the utility through rates as they are incurred; in exchange, the reasonableness of those fuel costs is examined retrospectively once each year. This is the only review given to such costs. Any disallowance the Commission may order signifies not only that a given cost was unreasonably incurred, but that the rates set earlier to collect that cost were also unreasonable. It is, emphatically, a rate case, the basic character of which is not altered because the form of review is adversary in nature.

A careful reading of the Commission's decisions confirms that such is not the case here.

1. The "Hindsight" Argument

SDG&E provides no authority, other than a passing reference to Webster's New Collegiate Dictionary, for the proposition that the federal right to due process would preclude the Commission from deciding the reasonableness issue through hindsight. More importantly, SDG&E's fundamental assumption that the Commission here used hindsight is erroneous.

In the case at bar, the Commission extended its retroactive review further back than usual because the reasonableness of the contract at issue had been specifically reserved and never considered. Several subsequent decisions approved expenses under that contract for specific periods of time, but the reasonableness of the contract itself had never been examined, nor had SDG&E ever asked for or received confirmation from the Commission that it considered the contract to be reasonable. In no sense of the word did the Commission's action in reaching back to review the reasonableness of the Restated Agreement constitute hindsight.

Furthermore, the Commission's conclusion on gas forecasts was based not on hindsight, but on the facts and circumstances existing at the time the Restated Agreement was entered into. In general, the gas forecasts being used at the time *were* overly pessimistic. But by late 1978, SDG&E had a significant history of using and formulating inaccurate forecasts. Ignoring past experience, SDG&E did absolutely nothing to evaluate the continued use of such forecasts before entering the Restated Agreement. The point is, as the Commission observed in its Final Opinion, that prudent utility management would have recognized in 1979 that since its forecasts had this highly uncertain history, the company should maintain and try to increase its fuel mix flexibility to allow for unexpected conditions. App. A61. This conclusion is hardly an application of hindsight.

2. The "No Substantial Evidence" Argument

SDG&E contends the Commission's findings and conclusions on the HIRI contract and on SDG&E's risk/benefit analysis are

not supported by substantial evidence. These claims are wholly without merit.

SDG&E alone had the burden of proving that its action in signing the Restated Agreement was reasonable. The Commission has stated that this burden means a party must show, through clear and convincing evidence with percipient witnesses, that its expenditures were reasonable. D. 92496, 4 Cal.P.U.C. 2d 693, 701 (1980); D. 83-05-036, unpublished (May 4, 1983).

The Commission's ultimate finding of unreasonableness was made after considering SDG&E's testimony and cross examination thereof. SDG&E had every opportunity to satisfy its burden of proof. The Commission properly found this burden had not been satisfied, and found SDG&E unreasonable in five particulars, two of which involved the HIRI contract option and SDG&E's risk/benefit analysis. D. 84-02-005, App. A16-A18, A21, A25; see also D. 84-12-026, App. A59-A63.[5] The Commis-

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[5] As a reading of the Commission's two decisions makes clear, SDG&E has misidentified the number of factors contributing to the Commission's unreasonableness finding. Jur.St. 17. There is, moreover, evidence sufficient to support both of the elements SDG&E criticizes.

Concerning the HIRI contract, the ALJ had taken official notice of SDG&E's consultant's report, the Gilbert Report (see p. 4 of this Motion, *supra*), during the reasonableness phase, without objection from SDG&E. R.T. at 3052-3053. That Report contained a table showing HIRI contract changes through Amendment 6 and proposed Amendment 7. The Commission's conclusions on the HIRI contract were based on the language of the contract, knowledge of SDG&E's and HIRI's past practices under the contract, and a proper inference drawn from SDG&E's own testimony that SDG&E had not seriously examined the HIRI option. See D. 84-02-005, App. A15-A17; Finding 14, App. A23.

SDG&E petitioned for rehearing on this issue. While the Commission did not grant rehearing, the ALJ specifically examined SDG&E's witness on the issue during the disallowance phase. By that point in the proceeding, SDG&E knew the Commission's conclusions on HIRI. It had an opportunity to refute them on the record. But its witness, when specifically questioned by the ALJ, was unable to do more than confirm the Commission's earlier conclusions. (R.T. 3573-3574; D. 84-12-026, App. A61-A62.)

sion drew different inferences from SDG&E's evidence than SDG&E hoped it would. But such is wholly within its prerogative as trier of fact, and does not constitute a denial of due process of law.

United States v. Abilene & Southern Ry. Co., 265 U.S. 274 (1924) is inapposite. In that case, this Court disapproved a commission's taking judicial notice of all the plaintiff carriers' annual reports on file with the commission *as a whole*, without notice to the parties as to just what information from those reports it was going to examine. In the instant case, the Gilbert Report addressed, in a more generic way, the very question at issue before this Commission, i.e., the reasonableness of SDG&E's fuel acquisition policies. Information on the HIRI contract was also available to the Commission through SDG&E's Exhibit 1 in the OSC proceeding (see p. 6 of this Motion, *supra*), and the contract itself was on file with the Commission. Even if it could possibly be construed that the Commission improperly went outside the record to get information on the HIRI contract during the reasonableness phase, this was completely cured during the disallowance phase. SDG&E has pointed to nothing denying it due process.

SDG&E's second assertion, on risk/benefit analysis, is equally without merit. The Interim Opinion goes through the analysis for four years of the contract. App. A16-A17. While the probability of excess LSFO was reduced in the first two years, this probability increased for 1981 and 1982 such that the net result came out just about even. Moreover, the only study relied on by SDG&E's witness had stated that the projected volumes under the Restated Agreement would have an expected value net savings of $500,000 over the base case of doing nothing to the existing contract; this is hardly the same as comparing benefits and burdens of the Restated Agreement itself.

The record amply supports the Commission's conclusions that the Restated Agreement provided marginal benefits at best, and those on a very short-term basis. More importantly, the record enabled the Commission to conclude that given SDG&E's almost complete failure to analyze other alternatives, this factor was one manifestation of SDG&E's imprudence.

Finally, SDG&E's argument that the shielding of shareholders element is irrelevant to a finding of unreasonableness (Jur.St. 17) is self-serving and finds no basis in the decision. See App. A17-A18, A21. It should be rejected out of hand.

It has long been the rule that this Court, in considering the question of sufficiency of evidence to support an administrative order, must and does rely largely upon a reviewing court's conclusion. *Radio Corporation of America v. United States*, 341 U.S. 412, 415 (1951); *Universal Camera Corp. v. National Labor Relations Board*, 340 U.S. 474, 491 (1951). This Court will normally not interfere with findings of fact of a state utilities commission which have been approved by a lower court. *United Gas Public Service Co. v. Texas*, 303 U.S. 123 (1938); *Georgia R. & Power Co. v. Railroad Comm.*, 262 U.S. 625 (1923). Here, the California Supreme Court has affirmed the Commission's interpretation of the evidence. SDG&E has given this Court no good reason to interfere with that judgment.

3. The "Alternative Action" Argument

SDG&E has never, throughout the course of this case, made any attempt to provide relevant authority for its assertion—raised only *after* the reasonableness decision had been issued—that the Commission had a duty to determine what a reasonable course of action would have been before determining a disallowance. SDG&E does present a lecture on principles of recovery of damages in tort law, but fails to demonstrate the relevancy of those principles or the cases it cites to public utility regulation, to the Commission's role in reviewing the reasonableness of fuel costs, or to this specific case.

Moreover, SDG&E by its own admission concedes the Commission's point on the issue of the excluded testimony. SDG&E states: "... it is the only evidence anyone offered which attempted to address the issue of what SDG&E should have done in 1979 with respect to its existing fuel supply status." Jur.St. 23. It was excluded because it addressed, if anything, the reasonableness of the Restated Agreement, an issue already decided, on which SDG&E had had its day in court. As the Final Opinion found, the testimony did not in any way address the actual consequences of the Restated Agreement or financial impact on SDG&E, the two issues reserved for consideration in the second phase of hearings. App. A59-A60. Its exclusion did not deny SDG&E due process of law.

4. The "Estoppel" Argument

SDG&E ends by recasting its earlier arguments into one which would have the Commission and not SDG&E responsible for SDG&E's having entered the Suspension Agreement. Thus it contends the Commission should be estopped from assessing to SDG&E's shareholders the $45 million in underlift charges the company had to pay under the terms of the Suspension Agreement.

Most importantly, this argument was not raised to the California Supreme Court. It is, therefore, improperly raised here, and should be rejected without further consideration. *United States v. Ortiz*, 422 U.S. 891, 898 (1975).

Moreover, the issue in this case is *not* the Suspension Agreement, but the Restated Agreement. But for the Restated Agreement, SDG&E would not have incurred those charges. They were, in the clearest sense, an "actual consequence," not of any Commission action, but of SDG&E's own decision to enter the Restated Agreement. It is hardly a denial of due process that the Commission imposed this disallowance, which is some $50 million below the highest figure supported by the record. App. A56.

CONCLUSION

For all of the foregoing reasons, this Court should dismiss SDG&E's claim for want of a substantial federal question.

Respectfully submitted,

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January 22, 1986

No. 85-1080

Supreme Court, U.S.
FILED
FEB 12 1986
JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

October Term, 1985

SAN DIEGO GAS & ELECTRIC COMPANY,

Appellant,

v.

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA,

Appellee.

ON APPEAL FROM THE SUPREME COURT OF CALIFORNIA

SAN DIEGO GAS & ELECTRIC COMPANY'S REPLY TO MOTIONS TO DISMISS OR AFFIRM OF THE CALIFORNIA PUBLIC UTILITIES COMMISSION AND THE CITY OF SAN DIEGO

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The City of San Diego (City) and the Public Utilities Commission of the State of California (Commission), respectively, filed a Motion to Dismiss or Affirm and a Motion to Dismiss (Motions) San Diego Gas & Electric Company's (SDG&E's) appeal herein. SDG&E files this response to those motions pursuant to Supreme Court Rule 16.5.

Overview

The constitutional deficiencies of the Commission's decisions, as raised by SDG&E in its Jurisdictional Statement, are confirmed by the failure of the Commission or City to squarely address them. For example, the Commission and City repeatedly refer to the asserted failure of SDG&E to meet its burden of proof as justification for the Commission's findings. Yet the Commission itself never invokes this as a basis for its findings in either of its decisions. And neither the Commission nor the City explain how the Commission could approve two-and-one-half years of SDG&E's expenses under the Restated Agreement, which earlier Commission staff testimony specifically supported as favorable, without having passed on the reasonableness of the contract itself. Nor do they explain how the Commission can now disapprove of the Restated Agreement *from its inception,* contrary to its earlier decisions, without having engaged in an unlawful hindsight analysis.

Moreover, the City argues that the "HIRI option" SDG&E gave up in signing the Restated Agreement was either to maintain current Hawaiian Independent Refinery, Inc. (HIRI) volumes or to more than double them for the last four years of the contract to 28,800 barrels per day. But the City fails to note that SDG&E's exercise of this "...flexible option to call on HIRI to deliver increased volumes..." (Interim Opinion, Appendix p. A-16) would have obligated SDG&E to purchase more than twice the amount of additional oil it actually purchased under the Restated Agreement!

The primary goal of the Commission's and City's Motions is to

obscure and divert this Court's attention from appellant's straightforward and substantial constitutional propositions. This is most clearly demonstrated by their perfunctory and conclusory responses to SDG&E's central theme in this appeal: That until the Commission takes evidence on and determines that course of action which SDG&E should have taken in 1979, the actual results of which can be compared to SDG&E's results under the Restated Agreement, the Commission shall be constitutionally constrained from determining the amount of expenses which should be disallowed. The Commission's adoption of an expense disallowance which has no causal nexus with SDG&E's actions is arbitrary and unconstitutional. *See Perkins v. Elg.*, 307 U.S. 325, 349-350 (1939). As SDG&E shall discuss in more detail below, the Commission's stance on this issue cries out for this Court's correction.

ARGUMENT

I.

NEITHER THE COMMISSION NOR CITY OFFER SUBSTANTIAL CHALLENGE TO SDG&E'S ASSERTION IT WAS DENIED DUE PROCESS BY THE COMMISSION'S FAILURE TO FIND ANY ALTERNATIVE ACTION WOULD HAVE AVOIDED THE DISALLOWED EXPENSES.

A. The Necessity For Determining A Standard Of Conduct.

The Commission argued to the California Supreme Court, and again asserts here that SDG&E has cited no authority for the proposition that the Commission had a duty to determine what SDG&E's reasonable course of action would have been before it calculates the "excessive" costs to be disallowed for ratemaking purposes. It disputes that civil tort case authority, requiring a causative nexus between the wrongdoing and the damage assessment, has any relevance to the Commission's action or regulatory law in general.

The proposition SDG&E advances here is so fundamental to damage assessment, and general logic, that it is incumbent upon the Commission to provide legal authority why appellant's position should be rejected, not vice versa. The Commission and its staff have consistently stressed that the $45 million disallowance assessment is neither a penalty nor a fine. The Commission's decision's challenged here make it abundantly clear that this disallowance is intended to constitute ratepayer *damages,* imposed to make them whole for SDG&E's imprudence. (Appendix, p. A-22.) This Court must judge the adequacy of the Commission's order on the same basis articulated by the Commission itself. *Securities & Exchange Commission v. Chenery Corp.,*318 U.S. 80 (1943). With that rationale at the heart of the order, how could civil damage case authority, representing literally hundreds of years of legal thought on this subject, be irrevelant? Yet the Commission's Motion shows disrespect for this fundamental legal precept of causation.

In truth, the Commission harbors not mere disrespect, but actual contempt, for the requirement of a causal relationship between utility imprudence and ratemaking disallowances or penalties. In recent decisions for SDG&E and Pacific Gas and Electic Company (PGandE), the Commission has imposed substantial disallowances/ penalties for certain ECAC expenses which the utilities were otherwise entitled to recover *without even a finding of unreasonableness.* (Decision Nos. 84-12-033; 85-12-104.)

The PGandE decision is particularly relevant. PGandE there sought cost recovery in an Energy Cost Adjustment Clause (ECAC) proceeding of amounts it expended to settle a lawsuit with Chevron U.S.A., Inc. (Chevron) over PGandE's termination of fuel oil deliveries under a long-term contract. Except for PGandE's terminating first and settling on payment later, its payment to Chevron was very analogous to SDG&E's $45 million payment to Tesoro under the Suspension Agreement to terminate the Restated Agreement. At the time of PGandE's payment, the Commission had in place a cost recovery mechanism (Annual Energy Rate, or AER) whereby

PGandE's shareholders were required to bear 9% of any unforecasted fuel related expenses. This mechanism was designed to provide PGandE with an incentive to economically manage its fuel costs, and actually gave it the opportunity to keep 9% of any fuel-related savings if its expenses were below forecasted levels.

But the 9% penalty which the Commission imposed without a finding of imprudence was *not* the 9% which PGandE already expected to absorb under the AER. This was an *additional* 9%, on top of the AER, of which PGandE had no notice when it negotiated its settlement, and which it could have avoided only by avoiding settlement, in contrast to the AER mechanism.

Similarly, the Commission's Decision 85-12-104 (of which SDG&E is currently seeking rehearing) disallows 8% of certain fuel oil disposal costs incurred by SDG&E, even though the Commission found SDG&E's actions were reasonable. (Decision 85-12-104, p. 6.)

The Commission called these disallowances "risk sharing," but they really are arbitrary state action, taken in the absence of evidence of imprudence and in open disregard of constitutional requirements. The Commission's disallowance of SDG&E's Tesoro contract expenses was no less arbitrary than its disallowance of PGandE's contract settlement expenses, or SDG&E's fuel disposal expenses, for it had no more evidence to support one than the others. If any vigor remains in the precept stated by this Court in *West Ohio Gas Co. v. Public Utilities Commission of Ohio (No. 1),* 294 U.S. 63, 72 (1935), that utilities are entitled to recover their reasonably incurred expenses, then it is essential that this Court reassert that the rules of ratemaking still require adherence to the United States Constitution. *Giaccio v. Pennsylvania,* 382 U.S. 399, 402-404 (1966).

B. SDG&E's Excluded Testimony Would Provide Evidence Of The Proper Standard

In this case that reassertion will include instructions that the

Commission admit the evidence of SDG&E's proffered witnesses who were prepared to testify to the consequences of the Restated Agreement. They were prepared to testify in the penalty phase hearings that there were no adverse consequences from the Restated Agreement because, even granting all of the Interim Opinion's criticisms of SDG&E, prudent management by SDG&E would not have resulted in SDG&E's ratepayers bearing a lower level of expenses. The Commission excluded the testimony, however, asserting that SDG&E was only attempting to "reargue" the reasonableness of the Restated Agreement, which the Commission had decided against SDG&E in the Interim Opinion. The Commission's decision never goes beyond this simple rationale for rejection, though, to analyze the alleged deficiencies of the testimony. While this constitutes an easy basis upon which to reject testimony the Commission did not want to hear, it is intellectually blind to the reasons for which SDG&E offered it, which was to provide evidence of the prudent course of conduct against which the Restated Agreement could be compared in order to ascertain its "actual consequences."

In fact, the Commission rejected this testimony only because of the ultimate conclusions the witnesses reached, not because the testimony attempted to justify the Restated Agreement—which it did not. The purpose expressly recognized in the prepared testimony of each of these witnesses was to consider, from the perspective of facts and circumstances as each understood them to exist in 1978 and 1979, what fuel strategy a utility situated like SDG&E should have followed at that time. Each discussed those facts and circumstances in some detail, including factors specific to SDG&E, and the various options in fuel strategies that were available to SDG&E. Each independently concluded that SDG&E should have sought to reduce its short-term powerplant oil supplies to take advantage of what was then considered to be the short-term availability of cheaper natural gas, but also should have attempted to line up reliable future oil supplies for the period when powerplant gas was not expected to be available. In general, each believed that the Tesoro Restated Agreement tended to conform to his recommended strategy.

But if these witnesses had reached some other conclusions, suggesting that a lower cost strategy than the Restated Agreement should have been pursued by SDG&E in 1979, SDG&E is certain the Commission would have embraced this testimony. There can be no misunderstanding on this point: The Commission rejected the testimony of SDG&E's consultants only because of its conclusions, not because of anything objectionable about its methodology or true purpose.

The Commission and City state SDG&E should have presented this testimony in the first hearing phase when the prudence of the Restated Agreement was at issue. SDG&E agrees this testimony would have been relevant there. But that fact did not make it irrelevant in the subsequent penalty phase hearings. For despite all the various assertions of the parties about the sufficiency of the evidence to support the Commission's findings and conclusions in its Interim Opinion, the Commission never made the one and only finding that could have justified its adopted expense disallowance, or any disallowance. Without a finding based on evidence of what the prudent course of conduct for SDG&E should have been, its findings could support neither its conclusion of imprudence nor any calculation of economic consequences.

Thus, SDG&E presented its outside consultant's testimony in the penalty hearing phase to provide an evidentiary basis on which the Commission could determine and measure the economic consequences of the Restated Agreement. That was precisely what the Commission ordered the parties to do in the Interim Opinion. (Appendix, p. A-22.) The Commission did not say, and could not have said, that such testimony would be objectionable if it failed to find actual adverse consequences. That SDG&E's excluded evidence showed no disallowance was appropriate was neither precluded by the Interim Opinion's findings nor rendered irrelevent thereby. The Interim Opinion's findings confined themselves to procedural and motivational wrongdoing that said nothing about ratepayer damages.

Accordingly, this Court should accept SDG&E's appeal to reverse the Commission's disallowance imposition and order the Commission to hear SDG&E's excluded evidence, thereby according SDG&E the due process to which it is entitled, but has heretofore been denied.

II.

THE EQUITABLE ESTOPPEL ARGUMENT WAS ADEQUATELY RAISED BELOW

The contention that SDG&E failed to raise an equitable estoppel argument in its earlier appeals is without merit. SDG&E's Jurisdictional Statement, at page 24, introduces the equitable estoppel argument under the heading:

> THE COMMISSION'S $45 MILLION DISALLOWANCE IS FUNDAMENTALLY UNFAIR IN LIGHT OF ITS PRIOR APPROVAL OF THE RESTATED AGREEMENT AND ITS FAILURE TO PROVIDE SDG&E ANY OPPORTUNITY TO MITIGATE ITS COSTS THEREUNDER.

SDG&E's previous filings have, in every instance, cited the factual and legal underpinnings of the equitable estoppel argument as it appears in the Jurisdictional Statement. If a litigant has brought a federal claim and the grounds therefore to the state court's attention with fair precision, and "...the record as a whole shows either expressly or by clear intendment that this was done, the claim is to be regarded as having been adequately presented." *New York ex. rel. Bryant v. Zimmerman,* 278 U.S. 63, 67 (1928); *Braniff Airways Inc. v. Nebraska State Board,* 347 U.S. 590, 598-599 (1954).

In SDG&E's Application for Rehearing of Decision 84-02-005 before the California Public Utilities Commission, the materials presenting the grounds for equitable estoppel are contained in pages 13 through 18 of the Application, and the argument is succinctly stated on page 19. In SDG&E's Petition for Writ of Review with California Supreme Court, filed on May 21, 1985, the factual and

legal bases for equitable estoppel are found at pages 15 through 18. In addition, SDG&E's Reply to Answers to the Petition for Writ of Review, which was filed with the California Supreme Court on July 19, 1985, contains the basis of the equitable estoppel argument on page 11.

As SDG&E's Jurisdictional Statement points out, the equitable estoppel argument is rooted in the concepts of fundamental fairness and due process. These grounds for review, as well as the factual basis for the equitable estoppel argument, have been repeatedly cited throughout SDG&E's appeals.

CONCLUSION

Neither the Commission nor the City have raised any dispositive objections to SDG&E's appeal herein, but have at best reaffirmed their inability to overcome the substantial constitutional infirmities of the Commission's decisions in question here. The Court should overrule their Motions for Dismissal and/or Affirmance.

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